

HOUSE OF LORDS

European Union Committee

10th Report of Session 2009–10

**The future
regulation of
derivatives
markets: is the EU
on the right track?**

Report with Evidence

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NOTE:

(Q) refers to a question in oral evidence

(p) refers to a page of written evidence

SUMMARY

This report examines the European Commission's Communications on *Ensuring efficient, safe and sound derivatives markets*. The regulation of derivatives markets is a complex subject. We had only a short time to complete this inquiry, and we do not attempt to come to definitive conclusions on any of the issues found in this report but rather to highlight key points in the forthcoming discussions on regulation of this complex area.

Derivatives are used by businesses to hedge against risks outside of their control, for example fluctuations in commodity prices. However, they are also used as tools for financial speculation. The lack of transparency in the derivatives market and the failure to identify a build-up in risk can cause market instability.

We found that the Commission proposals for increasing transparency in the so-called Over-the-Counter (OTC) derivatives market (see paragraph 8), through reporting OTC derivatives contracts which are not centrally cleared to a trade repository, will go some way to addressing concerns that the OTC derivatives market is opaque and ineffectively supervised. We also found support amongst witnesses for increased use of standardised contracts (see Box 6) and of central clearing (see paragraph 63). However, there are questions as to what types of contracts will be covered by the Commission's definition of derivatives. A consequence of a wide definition could be to extend application of the regulation to derivatives used by non-financial businesses that have little effect on financial stability.

The Commission suggestion that central clearing for all standardised products should be mandatory did raise some issues. This proposal if adopted could increase risk by forcing clearing houses to clear products for which they cannot manage the associated risk effectively. Moreover, not all derivatives contracts are suitable for standardisation. Applying capital charges to encourage standardisation, rather than on a basis proportionate to risk, could have adverse effects on stability and increase the costs of using derivatives to manage risk.

We found that the EU would be an appropriate level for regulation for minimum standards for central counterparties, provided that the standards mirror those developed at a global level. However, the suggestion of the Commission that the European Securities and Markets Authority (ESMA) would be an appropriate body to conduct authorisation and supervision of central counterparties met with some opposition from witnesses. We found that, in the absence of any cross-border fiscal burden-sharing arrangements for failing financial institutions, central counterparties cannot be supervised at an EU level because the EU itself does not have the financial resource within the budget to bail out a large central counterparty.

Overall we welcome the apparent direction of the Commission's proposals. We will scrutinise these in detail when they emerge in the form of a draft proposal.

The future regulation of derivatives markets: is the EU on the right track?

CHAPTER 1: INTRODUCTION

1. The derivatives market, along with many other sectors of the finance industry, has come under close scrutiny in the wake of the financial crisis of 2008. The European Commission has responded to the pressure for additional regulation of this sector by publishing two Communications suggesting future policy actions for the regulation of derivatives markets at an EU level.
2. This report focuses on these two Communications (henceforth “the first and second Communications”). The first Communication, *Ensuring efficient, safe and sound derivatives markets*, was published in July 2009. It presented the findings of an in-depth Commission review of the derivatives markets and launched a consultation on the regulation of derivatives markets.¹ The second Communication, *Ensuring efficient, safe and sound derivatives markets: Future policy actions*, published in October 2009, outlined “the policy actions the Commission intends to take in 2010 to ... meet the need for greater stability and transparency in these markets.”² The Commission Communications did not propose specific legislation. The Commission proposals are expected in spring 2010.
3. The financial crisis highlighted the significant role played by derivatives in the failures of Bear Stearns, Lehman Brothers and AIG (American Insurance Group) in 2008 and brought derivatives to the forefront of regulatory attention. Criticisms have been made in particular of the complexity and lack of transparency of the derivatives market, which reduced the ability of supervisors to identify risk. We examine in this report whether the Commission’s proposed future policy actions will improve this situation. The interlinkages in the financial system created by derivatives contracts have been blamed for spreading problems between financial institutions and we discuss this further in Chapter 2. The Commission Communications attempt to address these concerns by setting out ideas for the regulation of different aspects of derivatives markets.³
4. This report is a short review of the proposals and issues that may arise from the future policy actions suggested by the Commission and does not come to any definitive conclusions on the suggestions of the Communications. The current parliamentary session will be a short one and we had limited time to take oral evidence on this subject but thought it important to inform and to promote debate. The Commission’s proposals are still in an early state and we intend to return to this subject again in the next parliament.

¹ COM (2009) 332.

² COM (2009) 563.

³ In this report we take regulation to be the rules set down in legislation and supervision to ensure that financial institutions abide by these rules.

5. In addition to the Communications' proposals on the regulation of derivatives, there has been much discussion of a possible EU ban or further regulation of "naked" Credit Default Swaps⁴, primarily as a reaction to their suggested role in the recent Greek deficit crisis. The Financial Stability Board⁵ is also working on proposals for the regulation of derivatives markets. We do not comment on these discussions in this report, as we did not take evidence on these issues.
6. In the report we assess whether EU legislation for the derivatives market is appropriate. We examine what effect the proposals will have on market stability, and in particular whether they will address the criticised opaqueness of the derivatives market.
7. Some subsidiarity issues may be raised by the proposals when they are published. At this stage, when there are no proposals, we do not comment specifically on the subsidiarity implications.
8. The membership of Sub-Committee A which undertook this inquiry is set out in Appendix 1. We are grateful to those who submitted written and oral evidence, who are listed in Appendix 2; all the evidence is printed with this report. The evidence taken as part of this inquiry was taken in February 2010. Unfortunately, we were unable to take oral evidence from the Commission as part of the inquiry because it coincided with the end of the mandate of the first Barroso Commission. We are grateful for the supplementary letter the Commission was able to provide as part of this inquiry. There is a glossary in Appendix 4. We also thank the Sub-Committee's specialist adviser Professor Robert Kosowski, Assistant Professor in the Finance Group of Imperial College Business School, Imperial College London. **We make this report for information.**

What are derivatives?

9. A derivative is a financial instrument that derives its value from another financial asset, event or condition. Parties in a derivatives contract⁶ exchange cash or assets over time, based on the value of the underlying asset. As LCH.Clearnet, a leading clearing house for derivative products, explained, a derivative is "a means of either gaining exposure to or gaining an offset to an underlying asset without either buying or selling the underlying asset" (Q 100).
10. The International Swaps and Derivatives Association (ISDA) explained that:

"When a derivative contract is entered, one party to the deal typically wants to free itself of a specific risk, linked to its commercial activities, such as currency or interest rate risk, over a given time period. It is 'hedging'; and the more exact that hedge, the better for the hedging party.

"The other party to the deal assumes the risk, though it may then 'lay it off' elsewhere, in a process akin to reinsurance. Thus risk passes to those most willing to take it on (including investors, who are used to taking similar risks through other financial instruments)" (p 34).
11. Airlines provide an example of a derivatives contract, which is explained in detail in paragraph 26. They may take out a futures derivative to purchase

⁴ A credit default swap is a derivative which involves the buyer paying an annual fee to the seller until maturity of the contract, or until a credit event occurs on the underlying security (bond, loan or other financial asset). A "naked" CDS trade involves buying a CDS without ownership of the underlying security.

⁵ The Financial Stability Board is an international body which is intended to work toward increasing financial stability.

⁶ Parties to derivatives contracts are often referred to as counterparties.

some of their fuel in advance of its receipt at a fixed price, in order to lower the risks to their business associated with the volatility of fuel prices. A second example would be that of a company which engaged in cross-border trading, which may wish to take out a currency swap to buy a certain amount of foreign currency at a fixed exchange rate for a fixed length of time. This allows the company to hedge against the risk of volatility in exchange rates.

12. The European Union accounts for 66% of the global interest rate derivatives market and 60% of the global foreign exchange derivatives market.⁷ London alone accounts for 39% and 44% of these respective global markets (City of London Corporation, p 78).⁸ The US has 24% of the value of the global OTC derivatives market.⁹ While Asia currently constitutes a relative small part of the global OTC market, trading volumes are rising very fast. In Japan, the largest market in the region, the interest rate swap market grew by 47% between June 2007 and June 2009.¹⁰
13. The Commission Communications used the following definition of derivatives:

“Derivatives are financial contracts that trade and redistribute risks generated in the real economy, and are accordingly important tools for economic agents to transfer risk. They can be used both for hedging risk and to acquire risk with the aim of making profit.

“There are many types of derivatives. Some are standard products (e.g. futures) while others are not, as each contract is tailored to the specific needs of the user (e.g. swaps). The standardised derivatives are typically traded in organised trading venues where prices are publicly displayed (e.g. derivatives exchanges) while the non-standardised derivatives are traded off-exchange or, as commonly called, over-the-counter (OTC) where prices remain private.”
14. This definition, however, does not make it clear whether there will be exemptions from applicability of the regulation. For example, it might apply to a forward contract negotiated by a farmer to sell wheat at a specified price on a specified date. If such a contract were to be covered by EU regulations, it may lead to increased costs for the farmer, despite the fact that such a contract poses little apparent risk to the stability of the financial system.
15. The Commission working paper that accompanies the Communication noted that “a significant number of participants in these markets are not financial firms, but commercial producers hedging their price risks. Therefore, legislation designed for the financial sector may not be adequately tailored to their activity and risk profile. Indeed, this is reflected in a number of exemptions from EU financial legislation, such as MiFID¹¹ and CRD”.¹² We

⁷ An interest rate future is a financial derivative with an interest-bearing instrument as the underlying asset. Foreign exchange derivatives have currency as the underlying asset.

⁸ The City of London Corporation noted that 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

⁹ City of London, *Current Issues Affecting the OTC Derivatives Market and its Importance to London* (April 2009) p. 1.

¹⁰ Bank of Japan, *Results of the Regular Derivatives Market Statistics in Japan* (December 2009), p. 1.

¹¹ MiFID—The Markets in Financial Instruments Directive (COM (2006) 31) sets out basic provisions for conduct of business requirements and harmonises certain conditions governing the operation of regulated markets.

discuss the effect of the proposals on non-financial businesses in Chapter 4. **We recommend that the Government should invite the Commission to explain in detail which contracts will be covered by the definition of derivatives used in its proposed regulation, and clarify the scope of, and exemptions from, the regulation.** We will consider this point further when the proposals are published.

Types of derivatives

16. Derivatives can be traded either on or off exchange. Off-exchange derivatives are known as over-the-counter (OTC) derivatives. Over-the-counter (OTC) derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. OTC derivatives are often tailored to suit the needs of the parties. As a result they are not standardised (one of the preconditions for liquid exchange trading). In 2007 the market value of OTC derivative contracts was eight times greater than the equivalent value of exchange traded derivatives.¹³
17. The most common types of exchange traded derivatives are futures and options. Futures contracts are contracts to buy or sell an asset on or before a future date at a pre-specified price. Options provide the right (but not the obligation) to buy or sell a certain quantity of stock at a set price at a specific point in the future. Examples of exchange traded derivatives by asset class include:
 - *Interest rate derivatives*—a common exchange traded interest rate derivative is an interest-rate futures contract. An interest rate future is a financial derivative with an interest-bearing instrument as the underlying asset. This type of contract is typically used to manage interest rate exposure. A pension fund that holds government bonds, for example, could use interest rate futures as a cost-efficient way of reducing its interest rate exposure without having to sell its bonds. Exchange traded options linked to fixed-income instruments also exist. Interest rate futures and options make up the largest part of the exchange traded derivatives market (in terms of notional amounts).¹⁴
 - *Foreign exchange (FX) derivatives*—the most basic exchange-traded form of this derivative are FX futures. An FX futures contract involves buying one currency for another at a fixed rate over a period of time. This derivative is often used by companies who trade in foreign markets to reduce their exposure to fluctuations in the value of specific currencies. If an exporter, for example, will receive a cash flow denominated in a foreign currency on some future date, that business can lock in the current exchange rate by entering into an offsetting currency futures position that expires on same date as the cash flow.
 - *Equity derivatives*—exchange-traded equity derivatives take the form of futures on equity indices and options on equity indices or individual stocks. Hybrid instruments such as convertible bonds are also traded on

¹² CRD—The Capital Requirements Directive (COM (2006) 49) sets minimum levels of capital for financial institutions and has recently undergone several revisions.

¹³ City of London, Current Issues Affecting the OTC Derivatives Market p. 5.

¹⁴ A full breakdown of this data can be found in Box 1.

stock or bond exchanges. A pension fund, for example, that would like to protect its equity investments against a stock market drop could buy put (i.e. the right to sell at a given price) options that would increase in value as the stock index declines.

- *Commodity derivatives*—these are derivatives where the underlying asset is a physical commodity, for example, oil or wheat. Commodity futures are the most common exchange-traded commodity derivative, but exchange-traded options on commodities also exist. A producer that needs to buy agricultural products as ingredients for its products can use cocoa or coffee futures to hedge the risk of unexpected increases in its input prices.
18. Swaps, forwards and exotic options are the three main types of OTC derivatives. Forwards, like futures, are contracts to buy or sell an asset on or before a future date at a pre-specified price. A forward contract differs from a futures contract in that the futures contract is a standardised contract written by a clearing house that operates an exchange where the contract can be bought and sold, while a forward contract is a non-standardised contract written by the parties themselves. Forward contracts exist for all asset classes for which futures contracts exist. Exotic options are non-standard and tailor-made and are typically traded OTC. OTC Derivatives typically differ from their exchange traded counterparts in that they are tailor-made; the contract may have unusual maturities, more complex terms or involve several different types of currencies, for example. A swap is a derivative in which two counterparties exchange certain benefits of one party's financial instrument for those of the other party's financial instrument. The underlying financial instrument can belong to several asset classes:
- *Interest rate derivatives*—The largest part of the OTC market (in terms of notional amounts) is made up of interest rate derivatives.¹⁵ This type of contract is used to manage interest rate exposure. Interest rate swaps account for the majority of the notional amount of OTC interest rate derivatives. They involve a counterparty exchanging a variable or floating interest rate for a fixed interest rate to protect against the risks associated with a variable interest rate. A pension fund with future pension liabilities can use interest rate swaps to reduce its interest rate risk by transforming a floating interest rate liability into a fixed rate liability.
 - *Foreign exchange derivatives*—The most basic form of this type of derivative is a forward contract which involves buying one currency for another at a fixed rate over a period of time. A currency swap is another type of FX derivative. A multi-national company that plans to repatriate foreign currency holdings at a future date could use a forward contract to reduce the future exchange rate risk.
 - *Credit derivatives*—Derivatives that derive their value from the credit risk on an underlying bond, loan or other financial asset of a reference entity (the reference entity is the entity that issued the underlying asset and is not party to the swap). Credit Default Swaps (CDS) are the most common form of this derivative. A CDS involves the buyer paying an annual fee to the seller until maturity of the contract, or until a credit event occurs on the underlying entity. For example, a bank (the buyer)

¹⁵ See Bank of International Settlements OTC derivatives market by risk category and instrument in June 2009 (<http://www.bis.org/statistics/otcder/dt1920a.pdf>)

may pay a fixed fee to an insurance company on the basis that if a person were to default on their mortgage (the credit event) the insurer (the seller) would pay out.

- *Equity derivatives*—Derivatives where the underlying asset is equity. Equity-linked OTC derivatives make up only a small part of the OTC derivatives market. Swaps and exotic options linked to equity are common OTC equity derivatives. Equity swaps could be used to exchange a cash flow linked to an equity index against a fixed cash flow without incurring the transaction costs associated with selling the equity position.
- *Commodity derivatives*—OTC Forwards, swaps and options on commodities exist but account for the smallest part of the OTC derivatives market. A large oil-producing country could buy put options on the oil price to protect its revenue stream and fiscal position against an unexpected decline in oil prices.

BOX 1

The size of the OTC derivatives market in June 2009

The Bank of International Settlements (BIS) collects data from the central banks of G10 countries on the OTC derivatives market. The statistics presented below summarise the size of different sectors of the market in June 2009 (the latest figures available) in billions of US dollars. Although individual transactions are not recorded, these figures are constructed using the data central banks receive on the volume of OTC trades from banks. It is not possible to pinpoint specific transactions or risks that arise from transactions using the aggregate data.

	Notional amount outstanding (\$bn)	Gross market values (\$bn)
Foreign Exchange	48,775	2,470
Interest Rate	437,198	15,478
Equity	6,619	879
Commodity	3,729	689
CDS	36,046	2,987

Notional amounts outstanding are the gross nominal or notional value of all deals concluded and not yet settled on the reporting date. In other words, the total values of all contracts added together.

Notional amounts attract attention due to their large numerical values, but they are a misleading measure of the economic importance of derivatives markets. This is because derivatives contracts involve periodic payments based on the notional amount, but not the notional amount itself. Neither party to a derivatives contract will typically have to make a payment equal to the total notional value of the contract and so it does not represent credit exposure. The cost to exit the contract is the gross market value, which in 2009 was less than 5% of the notional amount for interest rate swaps. The gross market value may therefore be a better indicator of the economic importance of the contracts outstanding.

Gross market values represent the total outstanding cash between counterparties if all contracts are “netted out” (see Box 5).

Source: Bank of International Settlements, OTC derivatives market activity in the first half of 2009, November 2009

The Commission Communications

19. The first Communication argued that the huge growth of the OTC derivatives market and the increased volume of speculative positions built through derivatives justified a review of the derivatives regulatory framework. The financial crisis demonstrated that the risks associated with derivatives are not sufficiently mitigated in the OTC market. As the derivatives market is predominately organised in bilateral deals and not reported to any central body, supervisors and markets were not able to detect the risks. CDS pose particular worries as the risk they cover, credit risk, is not immediately transparent and obvious but requires the collection of specific information about the borrower and continuous monitoring.
20. In the light of these considerations, the Commission Communication set out four policy goals:
 - To enable regulators and supervisors to have an overview of the transactions that take place in OTC derivatives markets;
 - To increase the transparency and visibility of OTC derivatives;
 - To strengthen the operational efficiency of derivatives markets so as to ensure that OTC derivatives do not undermine financial stability; and
 - To mitigate counterparty risks.¹⁶
21. The first Communication also launched a consultation about policy tools—standardisation,¹⁷ central data repository, CCP clearing,¹⁸ trade execution— that could be used to remedy the flaws in derivatives market. The results of the consultation are contained as operational conclusions in the Commission’s second Communication, *Ensuring efficient, safe and sound derivatives markets: Future policy actions*, published in October 2009. This Communication outlined “the policy actions the Commission intends to take in 2010 to ... meet the need for greater stability and transparency in these markets”.¹⁹
22. The future policy actions outlined by the second Communication are summarised below and we return to them subsequently in detail in each chapter of this report. The proposals aim towards increased standardisation and increased transparency by requiring registration of derivative contracts and encouraging central counterparty clearing of most contracts. The Communication noted that “the proposed measures will shift derivatives markets from predominantly OTC bilateral to more centralised clearing and trading”. The following actions were proposed by the Communication:
 - Trade repositories: Trade repositories collect information on trades in the OTC derivatives market. The Commission argued it should be mandatory to report all OTC transactions to trade repositories and that the European Securities and Markets Authority (ESMA, see Box 2) should be responsible for the supervision and authorisation of repositories. Through reporting of trades

¹⁶ COM (2009) 332.

¹⁷ Standardisation refers to the standardisation of the OTC derivatives contracts to increase comparability and transparency. This is explained in detail in Chapter 4.

¹⁸ CCP clearing is where the derivatives contract is effectively split into two contracts, one between the buyer and the CCP and the other between the seller and the CCP. The CCP keeps track of the value of the underlying asset and pays out and receives collateral from the two counterparties accordingly. This is explained in detail in Chapter 4.

¹⁹ COM (2009) 563.

either through CCPs (for centrally cleared products) or trade repositories, Commission legislation will ensure supervisors will have a complete picture of the derivatives market as all derivatives contracts will be reported.

- **Standardisation:** The Commission identified the increased standardisation of contracts as playing an important role in increasing operational efficiency, the number of products eligible for central clearing and transparency. The Commission regards increased standardisation as a “core building block” in its proposals as it is a prerequisite for other actions.
- **Central clearing:** The Communication identified CCP clearing as the main tool to manage counterparty risk. The Commission intends to provide rules to ensure that CCPs ensure high standards of risk management. Possible legislation would also cover supervision and authorisation of EU CCPs and recognition of third country CCPs. ESMA will be responsible for the authorisation, and possibly supervision, of CCPs.
- **Collateralisation²⁰ in bilateral clearing:** Legislation will be proposed to require financial firms to provide initial margin and variation margin²¹ on bilateral contracts and to increase collateralisation of products that are not centrally cleared. The Communication noted that these requirements would provide an incentive to engage in central clearing.
- **Capital charges on bilateral clearing:** Proposed adjustments to the Capital Requirements Directive will widen the difference between capital charges on centrally cleared and bilaterally cleared products again providing an incentive for the development of central clearing.
- **Mandatory central clearing:** The Commission intends to make it mandatory to clear standardised derivatives through CCPs. The Communication does recognise that central clearing is not suitable for all derivatives products, a point made in many responses to the Commission consultation.

BOX 2

European Securities and Markets Authority

The European Supervision and Markets Authority (ESMA) would be one of three new European Supervisory Authorities (ESAs) suggested by the Commission in its proposals for a new supervisory structure for the European financial system. ESMA would be an EU standard-setting body that would replace CESR (the Committee of European Security Regulators).

The other two supervisory authorities would be the European Banking Authority (EBA), and the European Insurance and Occupational Pensions Authority (EIOPA).

The legislation instituting this new system for EU financial supervision is currently under discussion in the European institutions. The Committee discussed the proposals for the reform of EU financial supervision in the letter from Lord Roper to the Lord Myners, Financial Services Secretary to the Treasury, dated 25 November.²²

²⁰ Collateral is assets pledged by a party to secure a loan or other form of credit, and can be seized in event of default. Margin payments are a form of collateral specific to derivatives contracts.

²¹ Initial margin is the collateral counterparties have to set aside at the beginning of a derivatives contract to cover their obligations under the contract. Variation margin is the collateral that changes hands between counterparties based on the changing value of the underlying asset.

²² EU Sub-Committee A, *Correspondence with Ministers*: <http://www.parliament.uk/hleua>

23. The Communications drew on both the conclusions of the September 2009 Pittsburgh G20 summit and the conclusions of the de Larosière high-level group in 2009 on financial supervision in the EU. The G20 concluded:

All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.²³

The de Larosière group recommended that the EU simplify and standardise OTC derivatives and also introduce a well-capitalised central clearing house for credit default swaps in the EU.²⁴ The European Council of 19 June 2009 also called for further progress to be made to ensure the transparency and stability of derivatives markets.

BOX 3

The US and Asian approach to the regulation of derivatives markets

On 17 June 2009, the US Treasury Department released a White Paper entitled Financial Regulatory Reform, which prescribed mandatory clearing for all standardised OTC derivatives and more stringent capital and margin requirements for market participants.

In the US Senate, in September 2009, Senator Jack Reed introduced the Comprehensive Derivatives Regulation Act. This would:

- Require standardised derivatives transactions to be cleared, but not mandate exchange trading for cleared transactions.
- Require all OTC transactions to be reported to trade repositories.

In November, Senate Banking Committee Chairman Chris Dodd released a comprehensive financial regulatory reform bill, the Restoring American Financial Stability Act, which would establish a presumption of clearing for derivatives transactions. The bill would also mandate exchange-trading for cleared transactions and would grant the Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC) limited authority to exempt transactions from clearing requirements.²⁵

On 11 December 2009, The House of Representatives passed the Wall Street Reform and Consumer Protection Act by a vote of 223 to 202. The Act would;

- Require clearable swaps to be traded on an exchange or swap execution facility. End-users that use swaps to hedge commercial risks would be exempted.
- Allow counterparties to request the segregation of collateral.
- Limit aggregate clearing house ownership among swaps dealers, to 20%.
- Empower supervisors by requiring all swaps dealers and major swap participants to register with the SEC and CFTC.

²³ Leaders' Statement: The Pittsburgh Summit, 25 September 2009.

²⁴ De Larosière report, Report of the High-Level Group on financial supervision in the EU, 25 February 2009, p. 25.

²⁵ See <http://www.sifma.org/legislative/OTC/otc-derivatives.aspx?ID=11824> for a summary of recent US OTC derivatives proposals in the House of Representatives, Senate and executive branch.

Regulators in Asia are keen to reform their OTC derivatives markets to prevent problems such as those that affected OTC derivatives markets in the west from happening in their countries. At the same time they are concerned that the expected fast growth of reformed US- and EU-based clearing houses does not crowd out Asian clearing houses. Japan, India, China, Hong Kong, Singapore, Korea and Taiwan have all set up task forces to study setting up clearing operations for OTC derivatives markets, either by using existing clearing houses or by setting up clearers specifically for OTC derivatives. South Korea plans to follow the guidelines agreed by the G20 which would support global coordination and reduce the risk of regulatory arbitrage. The G20 agreement calls for standardised OTC derivatives to be, where appropriate, cleared and traded on exchanges. The Singapore Exchange, SGX, plans to become a regional hub for OTC clearing and is considering joining forces with other clearers such as the UK-based LCH.Clearnet. At the end of 2009, China launched the Shanghai Clearing house with the aim of clearing financial derivatives products for the Chinese interbank market. Although Shanghai Clearing house has not specified which products will be cleared it has been announced that they will include OTC transactions. On the other hand, some countries such as Taiwan and Australia do not appear to consider setting up a national CCP as a matter of urgency.

CHAPTER 2: DERIVATIVES: BENEFITS AND RISKS

24. An International Swaps and Derivatives Association (ISDA) survey of 2009 of the world's largest 500 companies ranked by revenue found that over 94% used derivative instruments to manage and hedge risk effectively.²⁶ It is therefore clear that they carry economic advantages for many businesses. However, derivatives have also become instruments of financial speculation and as such have received criticism for increasing risks in the financial sector and for their role in the financial crisis. We examine the benefits and risks associated with derivatives in this chapter.

Economic and commercial advantages of derivatives

25. Derivatives allow the sharing or redistribution of risk. They can be used to protect (hedge) against a specific exposure of a business (e.g. movements in asset price, exchange or interest rate, default of a creditor) or can be used by market participants to take on risk and speculate on the movement in the value of underlying assets, without ever owning the assets. MarketAxess, operator of an electronic trading platform for instruments including credit default swaps, told us derivatives contributed to the flow of capital and increased credit availability (p 115).
26. Derivatives can allow businesses to manage effectively exposures to external influences on their business over which they have no control. An example of this type of usage was provided by British Airways. Aviation is particularly exposed to fuel prices, with 32% of BA's operating expenditure spent on fuel in 2009. As the price of fuel can vary considerably, BA hedges this exposure through the use of derivatives, which allows the company to focus on its core business (pp 68–9). By taking out a futures derivative to purchase some of its fuel in advance of its receipt at a fixed price, they are protected against an increase in fuel prices. If prices fall below the level set in the contract, the loss made on the derivatives contract is offset by the lower cost of fuel that they buy in a conventional manner.
27. Some market operators have been criticised for using derivatives purely as tools for speculation. A derivatives contract involves one party reducing its risk, and the other taking on risk associated with an underlying asset. This allows parties to speculate on the values of underlying assets, without necessarily having any actual interest in the asset itself. This use of derivatives for speculating on prices, coupled with the lack of transparency in the derivatives market as a whole, can lead to parties taking on too much risk and potentially destabilising the financial system. Deutsche Bank told us that the losses sustained by AIG through their use of credit default swaps were because of “a massive corporate failure to manage the aggregate risk” rather than the derivatives model itself (p 82). As witnesses told us, **derivatives have sound economic and commercial benefits, and have been and remain necessary to the development of trade and commerce, but the manner in which they are used can pose a risk to the system.**

²⁶ International Derivatives and Swaps Association, *Research Notes: 2009 ISDA Derivatives Usage Survey*, No. 2, 2009.

Risks posed by derivatives

28. Lack of transparency has been highlighted as a key risk in the OTC derivatives market. A joint HM Treasury and Financial Services Authority paper, *Reforming OTC derivatives markets*, noted that “positions and exposures of firms in OTC derivatives markets were not sufficiently transparent to other market participants or to regulators.”²⁷ Market participants were unaware of overall market positions and build-ups in risk. This lack of transparency in relation to overall exposures can lead to an unwillingness to trade in a falling market and so reduce market liquidity. J.P. Morgan noted that the lack of information available to supervisors prevented proper supervision taking place (p 106). The lack of transparency means that supervisors are not able to monitor or mitigate systemic risks effectively.
29. In addition to the lack of transparency, the main risk associated with derivatives contracts is counterparty risk, that is, the risk that a counterparty in a derivatives contract will not satisfy its obligations under the contract, for example, by failing to supply goods in a futures contract. This could cause major problems to a counterparty that would be left suddenly without a derivatives contract and no longer receiving payments under the contract. The Managed Funds Association (MFA) explained to us that in practice large market participants use various techniques, including the posting of collateral either through mark-to-market margins (variation margin) and upfront margins (initial margin), to reduce counterparty risk to which they are exposed (p 111).
30. The MFA explained that both operational and systemic risks affect derivatives contracts. Operational risks are those that occur from human error or the failure of control systems. The MFA considered that the elimination of large backlogs of unconfirmed derivatives, standardised contract terms for OTC derivatives, improved processes and procedures for the physical settlement of underlying assets, and procedures for addressing valuation disputes have helped reduce operational risks (p 111).
31. Systemic risk describes the risk to the financial system posed by the default of a major player in the derivatives market. Interlinkages in the market created by the large number of derivatives contracts (see Box 1) means that the default of one party can have far-reaching implications for the creditworthiness of its counterparties. The Investment Management Association (IMA) referred to the “domino effect” caused by “financial firms connected through non-transparent OTC derivatives contracts.” Unmitigated, this can lead to systemic risk (p 104). This is clearly affected by the size of the counterparty: the larger the counterparty, the greater effect its default causes on the market as a whole.
32. Credit default swaps (CDS) are highlighted by the first Communication as “particularly vulnerable” to these risks. The risk associated with the underlying asset of a CDS, credit risk, is much more difficult to assess as only banks have access to specific information on the borrower, often leading to the underpricing of risk on CDS products. The complexity and opacity of CDS products makes it difficult for supervisors to spot dangerous distributions of risk.

²⁷ Financial Services Authority and HM Treasury, *Reforming OTC Derivatives Markets: A UK perspective*, December 2009, p. 5.

BOX 4**Credit default swaps**

Concerns have been raised about whether the CDS market functions efficiently and is sufficiently liquid or whether it is subject to potential price manipulation that may be destabilising. CDS have also been criticised for causing financial instability in particular when they are used as a pure speculative gamble. A so-called “naked” CDS trade involves buying a CDS without ownership of the underlying security. It has been argued that such a trade does not have a wider economic benefit as it is not used for hedging. In this context it is important to bear in mind that there are two counterparties to a CDS. Even in a CDS transaction in which a CDS buyer holds the underlying bond, the CDS seller needs to hedge its exposure. Moreover, a CDS can be replicated using the underlying bond and another interest rate derivative. A ban on CDS would likely lead to the use of options and shorting bonds to achieve the same economic exposures.

The argument that CDS are mispriced should also be carefully evaluated in the presence of evidence that CDS prices have been credited for providing investors with valuable signals of potential default risk in the run up to a borrower’s bankruptcy, while rating agencies were slow to warn of the impending risk. To the extent that bond yields and CDS spreads should in principle move in tandem, the question is therefore whether bond yields cause CDS spreads to increase or the other way round. In aggregate, spreads of risky bonds over safer bonds tend to be low in upswings and high in downturns, a business cycle pattern similar to that exhibited by CDS spreads.

The role of derivatives in the financial crisis of 2008

33. Most witnesses and commentators took the view that derivatives were involved in, but did not cause, the financial crisis of 2008, although some witnesses argued that CDS in particular played a very significant role. Lord Myners, Financial Services Secretary to the Treasury, told us however that although derivatives represented a significant part of the financial infrastructure “it is difficult to argue that the financial crisis was caused by derivatives” (Q 2).
34. The Commission argued in the first Communication that the crisis had shown “that the characteristics of OTC derivative markets—the private nature of contracting with limited public information, the complex web of mutual dependence, the difficulties of understanding the nature and level of risks—increase uncertainty in times of market stress and accordingly pose risks to financial stability.” It noted that while the difficulties experienced by Bear Stearns, Lehman Brothers and AIG during the crisis originated outside the derivatives market, the involvement of all three institutions in the OTC derivatives market, and in particular CDS contracts, spread those difficulties across the world economy. John Chapman, an ex-civil servant and now journalist, argued that CDS contracts in particular had a very significant role in the crisis, contributing through enabling speculation and shorting of financial institutions to the share price instability, which had necessitated the public rescue of AIG (p 76).
35. It is argued that the opacity of the market increased mistrust among participants which resulted in reduced liquidity. This opacity also prevented

regulators from spotting the build-up of risk in the financial system, which increased the consequences that the default of one of these companies would have for the financial system.

36. Other witnesses pointed to the involvement of derivatives in the collapse of Lehmann Brothers and AIG, both of which, in effect, were insuring banks against the default of their borrowers. More specifically, Deutsche Bank explained that AIG had taken on a large number of bespoke CDS, which were often too complex to be centrally cleared. As the value of the underlying assets declined with the bursting of the sub-prime mortgage bubble, AIG was forced to make significant payments to its counterparties and subsequently required financial support provided by the US Government to prevent its collapse (p 82).
37. The default of Lehmann Brothers in September 2008 was the first example of a major counterparty defaulting on obligations under OTC derivatives contracts. However, Deutsche Bank noted that despite Lehmann's default the majority of their OTC positions were "risk neutralised" and so their obligations to counterparties were managed effectively. Indeed the OTC derivatives market continued to operate effectively throughout the crisis (p. 82). The joint submission by the Wholesale Market Brokers' Association and the London Energy Brokers' Association (WMBA/LEBA) argued that "the financial crisis would have been more severe and even more far-reaching" without the continued operation of the OTC derivatives market (p 118). The joint paper submitted by ISDA, the British Banking Association (BBA), and the Association for Financial Markets in Europe (AFME) explained that when Lehman Brothers collapsed, it caused a notional amount of \$400 billion to become payable to holders of CDS contracts referenced against the insolvent entity (Lehman Brothers). However, after counterparties netted off amounts owed to them against amounts owed by them, the total net amount payable amounted to \$5.2 billion (p 20).

BOX 5

Netting agreements

Netting arrangements apply to bilateral deals and to centrally cleared transactions. Dealer institutions use so-called bilateral closeout netting agreements. A bilateral closeout netting agreement is a legally binding agreement between two parties stipulating that if one counterparty defaults, legal obligations arising from derivative transactions covered by the netting agreement must be based solely on the net value of such transactions. With a valid bilateral closeout netting agreement in place, a counterparty cannot simultaneously default on negatively valued derivative contracts while also continuing to demand payments on positively valued derivative contracts.

In CCP clearing the original contract between two counterparties is replaced with two contracts with the CCP. Any offsetting contracts between the counterparties are therefore extinguished. Margins are calculated based on the net position of a counterparty to the CCP. One of the positive consequences of CCP clearing is that any losses are mutualised over the entire member base, thus reducing contagion effects.

38. The Turner Review, a paper by the Financial Services Authority of March 2009 on the options for regulatory responses to the financial crisis, argued

that the complexity and opacity of the derivatives market meant that the default of one market participant could cause widespread market disruption. The report noted that, despite the fact that the OTC derivatives market operated as anticipated after the default of Lehman Brothers, this would not necessarily be the case in a future crisis.²⁸ The de Larosière report concluded that credit derivatives had overall a “significant” role in triggering the crisis and leading to a fall in confidence in the markets.²⁹

39. The lack of appropriate supervision of the derivatives market has also been suggested as a factor in increasing the crisis. Dr Chiari Oldani, lecturer in Economics, University of Viterbo, told us that the Bank of International Settlements had found that two thirds of the derivatives market were not appropriately monitored (p 116).
40. **Derivatives have an important economic function, namely redistribution of risk, but some forms of derivatives can be used as tools for speculation by participants in the financial market who have ownership of the underlying asset. Coupled with a lack of transparency in the market, where build-ups in risk cannot be detected by actors or supervisors, derivatives could help destabilise the financial system, particularly if there is a significant shift in the value of underlying assets.** As we took only limited evidence on the role of derivatives in the financial crisis, we do not come to a conclusion as to whether derivatives were a causative factor in this crisis, but it is clear that the systemic risks of derivatives were not, nor could they have been, fully identified, because of the opacity of the market.

²⁸ Financial Services Authority, The Turner Review: a regulatory response to the global financial crisis, March 2009, pp. 82–83.

²⁹ De Larosière report, p. 25.

CHAPTER 3: TRADE REPOSITORIES

41. Trade repositories facilitate the collection of information on trades in one or more segments of the OTC derivatives market for both CCP eligible and non-CCP eligible trades. The type of information collected by trade repositories includes the number of outstanding contracts, size of outstanding positions in a particular contract and exposures of a specific entity. Through trade repositories supervisors can obtain information on the number of contracts and size of outstanding positions in the market.
42. The Commission proposes that all OTC transactions are to be reported to an appropriate repository to enhance regulatory oversight of macro-prudential (system wide) and micro-prudential (specific to an individual institution) risk. The finance industry is already making good progress in establishing trade repositories. By making the reporting of bilateral contracts to trade repositories compulsory and increasing the use of CCPs (see chapters 4 and 5) the Commission intends to ensure that all derivatives contracts are reported. This will increase the transparency of the derivatives market and information available to supervisors about risks in the system as a whole.
43. The Commission intends to propose legislation governing trade repositories as well as imposing new reporting obligations on market participants. Legislation will provide a common legal framework for the operation of trade repositories and will include requirements for authorisation and registration, access, disclosure and safeguarding of data and governance and operational reliability.
44. Our witnesses were widely supportive of the introduction of repositories. According to Chatham Financial, who provide independent interest rate and foreign currency risk management advise to clients, trade repositories will allow supervisors, for the first time, to see the entire derivatives market and will enable them to detect the precise location of systemic risk (p 77). For Argus Media, an energy market price reporting service, trade repositories will increase transparency of counterparty risk and positions in OTC derivatives markets (p 51).
45. The Managed Funds Association (MFA) supported the use of trade repositories to record non-cleared OTC derivatives contracts. They suggested that “trade repositories will enhance market transparency for regulators and will reduce systemic risk by ensuring that regulators have a comprehensive picture of market concentrations and exposures within a given asset class” (p 113).
46. The FSA and the Treasury agreed that the introduction of trade repositories would be fundamental in improving transparency as they would help supervisors to identify potential sources of concentration of risk and market instability (p 2).
47. On the other hand, ISDA, BBA and AFME, in their joint response, urged caution regarding the disclosure to the public of information held by a trade repository (p 18). The City of London Corporation agreed that full disclosure of trades and positions to supervisors was critical to ensure they were adequately informed, but that making detailed trade information publicly available “might undermine the ability of the market to execute large orders” (p 80).

48. Chatham Financial argued that repositories should be regulated as utilities to prevent uncompetitive practice, and they should not have the ability to use collected data for commercial purposes (p 77).
49. The Government told us that all market participants, speculative participants, supervisors and those with an interest in the market should have access to repositories' databases. The Minister concluded that "the essence of the repository has to be full visibility to facilitate informed and efficient markets" (Q 60).
50. **We agree with the future policy actions suggested by the Commission to increase transparency in the OTC derivative markets by supporting the use of trade repositories to record OTC derivatives contracts to ensure all trades in the market are reported. Trade repositories should enhance market transparency for regulators and reduce systemic risk by ensuring that supervisors have a comprehensive picture of market concentrations and exposure within a given asset class and allow supervisors to more accurately identify the misuse of derivatives. Further consideration should be given to access to data held by trade repositories.**

The location, regulation and supervision of trade repositories

51. Despite the wide support for trade repositories, witnesses noted issues including establishing the appropriate location of repositories and the level of supervision and the responsible supervisory authority.
52. The Commission believed that ESMA should be responsible for authorising and supervising trade repositories. The Commission does not require trade repositories to be located in Europe as ESMA should also be responsible for authorising the operation of third-country repositories in the EU on the basis of equivalence of the regulatory framework. On a reciprocal basis, ESMA should ensure that European supervisors have access to complete global information. In the absence of such access, the Commission intends to encourage the creation and operation of Europe-based trade repositories.
53. Witnesses' opinions diverged on location, supervision and regulation of trade repositories. IMA argued that "there could be benefit in a legal framework and supervisory regime for trade repositories being specified at European level, so long as this does not also require different derivative markets to operate with a trade repository in them" (p 105). The Futures and Options Association (FOA) preferred trade repositories to be licensed and supervised by their national supervisory authorities in accordance with global standards, rather than by ESMA. However, they also argued that the key concern is the quality of licensing, regulation and supervision, rather than by whom it is undertaken or where a trade repository is based (p 91).
54. Antonio Sáinz de Vicuña, of the European Central Bank, argued that in his view (which did not necessarily represent those of the ECB), ESMA should not become "a proper EU supervisor... before the time where there is a single set of rules that a EU supervisor may apply." He continued "ESMA is to be only a European Agency with regulated functions vis-à-vis national supervisors, which may play a useful role to standardise approaches and practices, and coordinate supervision" (p 117).
55. ISDA, BBA and AFME did not believe that trade repositories should be established on a regional basis, or that trades should be divided into

“European” and “non-European” in order to be registered in a European or non-European trade repository. They commented that “there should be only one trade repository per asset class globally to avoid fragmentation of data” (p 23). Similarly, J.P. Morgan argued that harmonised global regulatory standards should be developed for trade repositories given the global nature of OTC derivatives markets (p 107).

56. When questioned on whether the regulation and supervision of a trade repository should take place at national or EU level, the Government told us that trade repositories “do not need to be within the EU; they do not need to be within the UK. The crucial thing is that they are well run and they will provide that information to the users and to the regulators so that the transparency is there” (Q 61).
57. **Whilst the regulatory framework for trade repositories should be at the EU level and reflect globally agreed standards, further consideration should be given to the appropriate level of supervision within the EU.**

CHAPTER 4: STANDARDISATION AND CENTRAL COUNTERPARTY CLEARING OF OTC DERIVATIVES CONTRACTS

Standardisation

58. OTC derivatives products can range from the highly standardised to bespoke and complex. In the Commission's view, standardised contracts should become the norm and are desirable irrespective whether these products are bilateral, cleared or traded on an exchange. For the Commission, standardisation is a "core building block" to making derivatives markets safer as a large number of non-standardised products can reduce transparency. Standardisation increases legal certainty and operational efficiency by enabling automation of the structure of the trading and post-trading value chain. Standardisation also helps to reduce counterparty credit risk, by widening the use of CCP clearing or exchange trading. However, the Commission recognises that a market for bespoke derivatives products will always exist to cater for the needs of firms who have particular hedging needs.

BOX 6

Standardisation of derivatives

In the consultation document the Commission differentiated between (i) standardisation of "the contractual parameters" and (ii) a less restrictive standardisation of the contracts themselves to support market infrastructure.

Contractual standardisation implied by (ii) may be beneficial since it may facilitate the use of electronic trading and settlement. Electronic trading can lead to a more robust infrastructure since processes have to be streamlined for it and it increases the ease of trading. Similarly, electronic settlement as opposed to paper-based processing is likely to be more robust since processes have to be more reliable for electronic trading to be possible.

Examples of this are Interest Rate Swaps and Credit Default Swaps where electronic systems have been developed to reduce operational risks without impacting on contract flexibility. Such standardisation may facilitate automatic processing, increase efficiency and reduce operational risks by, for example, encouraging electronic affirmation and confirmation services, central storage, automation of payments and collateral management processes.

The standardisation of the contracts themselves ((ii) above) does not require standardisation of the risk profiles that derivative users can achieve by buying such contracts. It may for example be possible to buy multiple units of certain standardised contracts or combine different maturities. Standardisation of contractual parameters (i), on the other hand, would imply standardisation of the parameters such as coupons, strike prices, maturities, etc., and may affect the ability of derivatives users to hedge particular risks. It may be possible to standardise contracts to facilitate use of electronic systems without significantly constraining the contractual parameters.

59. The Commission intends to set European targets for legal and process standardisations and the industry has already made progress in pursuing standardisation. Following an initiative by the International Swaps and

Derivatives Association (ISDA), the standardisation of North American CDS contracts began in April 2009 and trading of standardised European CDS contracts began in July 2009.

60. Witnesses were largely supportive of efforts to increase standardisation of OTC derivatives products. The City of London Corporation noted support for further standardisation, where practicable, through improvements in automation and contract standardisation (p 78). The Government told us that “the advantage of standardised contracts lies in facilitating greater comparability between products, promoting more liquid markets and enhancing price discovery” (Q 10). They added “standardised contracts will enhance visibility and transparency” (Q 23).
61. In their supplementary evidence, the Government explained in more detail the advantages of standardisation. They noted that the optimal level of standardisation varied according to the different types of derivatives. The regulatory focus is on equity derivatives which are less standardised due to the different needs of the market participants. While the Government encouraged standardisation, they recognised that “a proportion of the OTC derivative market will always reflect demand for bespoke products” (p 17).³⁰
62. **We welcome Commission and industry efforts to encourage standardisation in derivatives products. We agree with the Government and the Commission that standardised contracts can help improve transparency and stability in the OTC derivatives markets. However we note that not all products can be standardised and that room must be left, in an efficient market, for bespoke derivatives that meet the specific needs of corporates.**

What does a CCP do and how does it operate?

63. The Commission also recommends that as many contracts as possible should be cleared through a central counterparty. A bilateral OTC derivatives contract takes place between two parties, the buyer and the seller. When a contract is centrally cleared the single transaction is replaced with two transactions each involving a third party, the central counterparty (CCP). As LCH.Clearnet, a CCP clearing house, explained to us “the central counterparty stands in and becomes the seller to the buyer and the buyer to the seller.” The CCP “effectively reduces the level of activity and nets down all the risk, and then stands in the middle and applies margin and takes collateral from each of the counterparties” (Q 101). The CCP monitors the value of the underlying assets on which the derivative contracts are based and collects and releases collateral from the counterparties based on the value of the asset. As the change in value of an underlying asset means that one counterparty gains as another loses, the overall net change is much lower (close to zero) than the gross value of the contracts. Lord Myners explained that every day the CCP would receive “modest payments” from counterparties whose contract moved against them, “to ensure that the CCP, or those that participate through the CCP, always have funds to satisfy their obligations under contracts” (Q 27).

³⁰ The City of London also noted that not all products can be standardised (p 78).

BOX 7**Core Functions in Clearing, Settlement and Custody**

In their response to the Commission Communication, *Clearing and Settlement in the European Union*, (COM(2004)312), the European Association of Central Counterparty Clearing Houses gave the following explanation of the clearing process in the Annex *Functional definition of a Central Counterparty Clearing House (CCP)*:³¹

“The value chain can be broken down into three main functions:

(1) Clearing, (2) Settlement, (3) Custody

(1) Clearing

After the execution of buy and sell orders, transactions are processed in preparation for the transfer of ownership of the product and the fulfilment of all obligations. Depending on the institution providing this service, several additional services are performed, such as the netting of obligations to ensure fewer processes and cash flows, and in particular the evaluation and management of all relevant sources of risk in order to reduce the probability of failure to meet obligations.

In most cases, this function is performed on different levels; firstly by trading parties for their clients, secondly at central counterparty clearing houses (CCP Clearing) and thirdly at central security depositories (CSD/ICSD Clearing) or banking institutions (for internal executions) for public market participants.

With regard to the various different clearing levels, it has to be taken into consideration that the clearing performed by a CCP is different from that performed by a CSD. CCP clearing concentrates on trade management, position management, collateral and risk management, and delivery management. Due to these specifications, CCP clearing takes place prior to the clearing performed by CSDs. CSD clearing concentrates on validating and matching the delivery instructions; the result of which is forwarded to settlement.

(2) Settlement

At due date when the obligation is settled, then the ownership of the product is transferred. This process involves matching the buy and sell instructions and subsequently renewing the product's ownership, as well as transferring the related cash. Transactions involving securities are usually settled on a delivery-versus-payment (DVP) basis. Once again, netting can be used in this process to reduce the number of settlement transactions, if this has not already been done by a central counterparty as part of the clearing process.

Several institutions are involved in this process, since settlement can be effected using netting within a central counterparty process, as a facilitation service provided by central security depositories in conjunction with their custodian services and central banks or correspondent banks. In the case of internal trade, however, this process is also performed by banking institutions.

(3) Custody

Instead of holding physical products at the beneficiaries' premises, the financial industry has organized itself in such a way as to localize financial products at central but national custodians. These custodians fall under the functional

³¹ This document can be found online at:

http://ec.europa.eu/internal_market/financial-markets/docs/clearing/2004-consultation/each_en.pdf

definition of central security depositories (CSDs). The advantage of this system is that these CSDs are very close to the issuer and are able to process corporate transactions as efficiently as possible while taking the relevant law and tax requirements into account. In addition to the CSDs, a number of other market participants offer the same service. These participants are often members of the CSDs that offer the custody service to their clients. In some cases, however, they are prime custodians that have a direct relationship with the issuer.

There is a third group of custodians, namely those that have a relationship with local CSDs or custodian banks and consolidate cross-border custody services. Sometimes these custodians even offer cross-border settlement services, either due a lack of efficiency within the local settlement environment or to the internalization of transactions. These market participants are known as international central security depositories (ICSDs) or global custodian banks.”

64. The Commission working document summarised the following advantages of using a CCP:

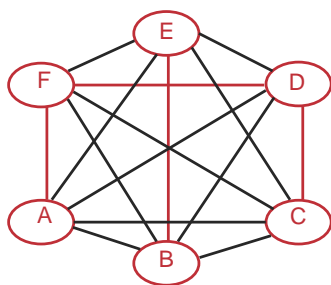
- It allows risk mitigation and mutualisation of losses through “netting out” contracts.
- It has a positive effect on market liquidity.
- It solves disruptive information problems, providing a central data source.
- It increases operational efficiency.

FIGURE 1

Bilateral Vs CCP Clearing

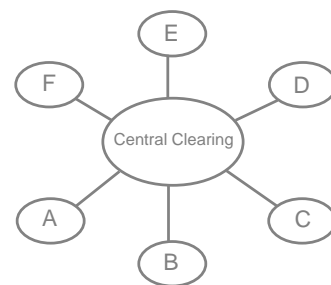
Bilateral clearing

- Web of counterparty exposure
- Complex collateral movements
- Potential domino effect of one dealer default



CCP clearing

- Hub and spoke with central guarantor
- All collateral moves to/from CCP
- CCP capitalised to withstand dealer default



From COM (2009) 332, p. 7.

65. The first Communication noted that a CCP “is effectively a mutual insurance with mutual defences”. Having a CCP collect and manage collateral simplifies collateral management. It also makes transactions safer as the CCP is “solely focused on managing risks” and should have a strong understanding of the risks they are taking. The information collected by a CCP also makes it easier for the supervisor to monitor risks in the market.

66. The Communication set out the following reasons why market participants may not universally use CCP clearing:

- Using a CCP can increase the costs to participants in a CCP contract.
- A CCP improves transparency, which is to the disadvantage of major OTC derivatives dealers who currently enjoy an “informational advantage” over other market participants.
- Not all OTC derivatives fulfil the necessary characteristics to be cleared by a CCP.

Will increasing the proportion of contracts cleared centrally increase stability?

67. The Commission proposals aim “to meet the need for greater stability” in the derivatives market in part through increasing the proportion of derivatives trades that are centrally cleared. We asked witnesses whether this would reduce risk to the stability of the financial market posed by derivatives.
68. LCH.Clearnet gave the following explanation of how using a CCP reduces risk:
- “A given firm can take the level of risk it wants to take, and putting its transaction all through [a] central clearing house does not reduce the level of risk that that has got. What it does is reduces the level of risk that that counterparty would represent to all of its counterparties, so it reduces the consequences of a defaulting member on others but it does not reduce the probability of a member defaulting” (Q 103).
69. They went on to explain their own risk management procedures. On a day-to-day basis the CCP recalculates the value of transactions and accordingly calls or releases collateral, ensuring counterparties have neutral risk positions in relation to the value of the underlying asset. On top of this, counterparties post initial collateral, based on the level of risk of that counterparty as assessed by the CCP. For LCH.Clearnet, this initial margin totalled £50 billion. In addition, LCH.Clearnet had a default fund of £600m and own capital resources of €300m. This capital was used to settle counterparties’ positions in the case of their default. This system has already proved its value: in the case of Lehman Brothers, their initial margin was \$2bn and only 35% of this was used by LCH.Clearnet to liquidate the portfolio and settle outstanding obligations to counterparties (Q 106). The existence of this margin allowed Lehman Brothers to default without significant adverse effects on its counterparties in derivatives contracts.
70. The Minister agreed that the CCP model is designed to ensure that counterparties have the ability to settle contracts, which in turn will increase confidence in the system (Q 47). ISDA agreed that while existing systems to manage counterparty risk were shown to be effective in the crisis, “CCPs provide some additional benefit” (Q 70). While ICAP commented on the benefits of central clearing and themselves had worked to encourage central clearing, they noted that it “is not a cure-all panacea” (p 96).
71. ISDA explained that a CCP carried out multilateral netting. As explained in Box 5, netting is the process of calculating where counterparty credit exposures cancel each other out. Multilateral netting is where this process is carried out involving more than one party at a time, and in doing so calculating the total exposures across the multiple parties. A CCP can carry out multilateral netting between all of its counterparties, taking and receiving

collateral where appropriate, and developing a better overall picture of exposures and risks

72. As discussed in paragraph 37, once counterparties netted amounts they owed on CDS contracts based on Lehman Brothers' default against amounts they were due to receive after the default, the notional total payable of \$400 billion was reduced to \$5.2 billion (p 20). A CCP allows this netting to be carried out against all the contracts it clears, thus providing a much clearer picture on the total net amount owed on derivatives contracts, as opposed to the often misleading figure of the notional total payable on contracts (see Box 1).
73. The Turner Review argued that netting-out of bilateral positions would reduce unnecessary multiplication of gross exposures, a process which would be "greatly assisted" by the use of CCP clearing.³² The Commission agreed that increasing clearing would reduce counterparty credit risk, increase netting effects and ensure more collateral is collected to cover exposures (p 87). The first Communication noted that transparency would improve as a result of increased CCP clearing as information on market positions would be available in a single location to supervisors.
74. **We welcome the approach of the Commission in looking at ways to increase the proportion of contracts centrally cleared in order to reduce systemic risk. However, as the Commission recognises, central clearing is not a feasible option for all investors and all contracts. Increased use of CCPs should increase transparency in the sector by providing centralised locations for data on overall market positions, by ensuring that all derivatives contracts are reported and by enabling a clearer view of the total net amount owed on derivatives contracts.** We consider the systemic risk posed by CCPs themselves in Chapter 5.

Standardisation and central clearing

75. In line with the G20 conclusions that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate" the Commission intends to make it mandatory to clear standardised products through a CCP. The second Communication acknowledges that not all derivatives contracts would be suitable for central clearing as either they are specific to the trade concerned or because, even if standardised, the product is not liquid enough for central clearing. Indeed seeking to impose a condition that all standardised contracts must be centrally cleared would be unworkable given the present structure of CCPs, all of which are private companies who do not have to accept a contract for central clearing if they are uncomfortable with the profile or the implications for liquidity.
76. The Commission intends to promote further standardisation for non-clearing eligible OTC contracts while recognising that incentives may be necessary for the industry to use standardised contracts for derivatives that are unlikely to be eligible for CCP clearing and unsuited to on-exchange trading. The Communication argued that capital charges will provide the necessary incentives towards standardisation and CCP clearing.

³² The Turner Review, pp. 82–83.

77. We discussed with our witnesses whether standardisation is a necessary condition for central clearing. LCH.Clearnet made the point that transactions do not have to be standardised to be cleared, suggesting that “it is easier if they are standardised, but the swap portfolio we have is simple and vanilla in its risk but not standardised in terms of transactions”(Q 126).
78. The Futures and Options Association (FOA) questioned whether standardisation was a suitable criterion to determine whether an OTC contract should be eligible for CCP clearing. There were other equally important criteria to consider in determining clearing eligibility, such as price transparency, liquidity, volatility and the risk management capability of the CCP (p 90).
79. ISDA explained that “you can have standardised products which are not liquid... making the clearing of all OTC derivatives mandatory would be very dangerous because you would include instruments that were not appropriate for clearing” (Q 73). Argus Media, an energy market intelligence and price reporting service, agreed that mandatory clearing could force CCPs to undertake “types of clearing risk that it would be unable to effectively manage” (p 51).
80. The Government endorsed these arguments. Not all standardised contracts could be cleared safely by a CCP as a standardised contract might “not have regular availability of pricing, it does not have the depth of market liquidity and so the ability of the CCP to effectively manage the risk is not there” (Q 11). The Minister also made the point that a great push for standardisation should not stifle innovation: “we should be seeking to encourage standardised contracts and central clearing, but on the other hand we do not want to inhibit innovation or make it more difficult for businesses or investors to secure the precise risk reduction that they wish to establish through a derivative contract” (Q 11).
81. Chatham Financial made the additional point that mandatory clearing would also increase liquidity risk of companies using derivatives, by forcing “non-systemically important commercial end-users to divert precious working capital from more productive uses in order to satisfy clearing house margin calls” (p 77). We discuss the cost of central clearing in paragraph 105.
82. There were also questions about what should be considered as a standard derivative contract. The law firm Ashurst LLP argued that mandatory clearing would create uncertainty for any contractual arrangements which could be defined as a standard derivative. Eventually “the concern may turn out to be how to stop financial institutions using CCPs for non-standard contracts.” Ashurst noted this uncertainty may create an “industry for lawyers giving opinions” (p 55).
83. **We agree that standardisation should not lead to compulsory CCP clearing eligibility. Similarly, a lack of standardisation should not necessarily indicate clearing ineligibility.**
84. **The Government should encourage the Commission to define carefully in the final proposal which contracts should be regarded as both standardised and appropriate for central clearing. CCPs should not be allowed to clear a product if they are not prepared to manage the risk. CCPs are privately owned companies, which can currently refuse to clear products where they feel they cannot manage the**

associated risk and this system has worked well even during the financial crisis.

Central clearing: should it be made mandatory, incentivised through capital charges or both?

85. The prevailing view amongst our witnesses was that central clearing should not be mandatory for standardised products. In the Communications, the Commission also proposed that financial firms entering into non-standardised contracts would be required through regulation to post initial margin in proportion to the risk profile of the counterparty and variation margin in relation to the change in value of the contract over time. In addition to mitigating the risk of default, these measures were intended to dissuade financial operators from entering into non-standardised contracts which could otherwise have been standardised and cleared centrally.
86. The Investment Management Association argued that central clearing should be incentivised by variable capital treatment of centrally cleared versus bilateral contracts as “this is the only way in which a reasonable separation between vanilla and complex products is likely to be achieved” (p 104). LCH.Clearnet told us that, while they had concerns over making clearing mandatory, they were in favour of the Commission encouraging clearing through favourable capital treatment of cleared products, although this should not be through “penalties attached to non netted products” (Q 126). ISDA explained that “if you have a situation where it is possible to define which products are eligible for clearing... then provided that you get the incentives right it should not be necessary to make it mandatory” (Q 73).
87. The City of London Corporation insisted that central clearing should not be mandatory but “left to the discretion of the clearing members” as their capital might be put at risk to support a clearing house. They continued that “if mandatory clearing forces CCPs to clear products that are not suitable for clearing, it could increase systemic risk and increase costs for end-users” (p 79).
88. The FSA and the Treasury argued that the proposal to require CCP clearing for standardised products could be counter-productive. Other considerations including availability of pricing, market liquidity and ability of the CCP to manage risk effectively had to be considered alongside standardisation in determining whether a product was eligible for clearing. If it were mandatory to clear standardised products, these other criteria would not be considered and as such could “ultimately lead to greater risk in the system”. They expressed support for an approach where regulators set “extremely high and challenging” targets for CCP usage (p 2). ISDA told us that targets for clearing 70% of eligible interest rate swaps and 80% of eligible credit derivatives were met in autumn 2009 (p 35).
89. The Commission made it clear in its letter to us that the two options—mandatory clearing and incentives through capital requirements—were not mutually exclusive. They explained that “capital requirements are first and foremost established to cover a bank’s exposures to risks and not primarily as a tool to achieve wider policy objectives, thus they should be proportionate to actual risks faced by banks” (pp 86–7). Since capital requirements would not be sufficient to cover the risks to financial stability caused by the behaviour of market operators, capital requirements needed to be complemented by mandatory clearing of eligible standardised contracts and clearing targets.

The Commission concluded that the real challenge would be to structure a clearing obligation which would actually decrease systemic risk.

90. **Increased standardisation and central clearing of OTC derivatives can increase transparency and stability. However, not all products, nor all standardised products, are suitable for central clearing. Legislation should avoid forcing these products through central clearing as this may increase risk in the system if a CCP cannot effectively manage the risk associated with a product.**

Capital treatment

91. We discussed with witnesses whether higher capital charges should be applied to trades not centrally cleared and to non-standardised derivatives contracts.
92. Eurelectric, who represent the European electricity industry, argued that capital charges should not be used as a penalty to incentivise standardisation, clearing through CCPs and trading on regulated platforms. They should be instead be proportionate to risk (p 85). Chatham Financial agreed charges should reflect risk, to promote the soundness of the financial system (p 77).
93. Deutsche Bank explained that non-centrally cleared trades already attracted higher capital charges than those cleared centrally. They argued that it was “reasonable that a capital differentiation should continue to exist between trades cleared on CCPs and those not centrally cleared (non-standardised contracts or standardised contracts ineligible for clearing)” although they did not suggest this should be applied through legislation (p 83).
94. The Managed Funds Association (MFA) believed that it was appropriate for regulators to impose higher capital charges on trades eligible for central clearing but not centrally cleared, but added that it was critical to provide market participants with the ability to engage in non-standardised or customised derivatives contracts without facing overly burdensome capital charges (p 113).
95. The FSA and the Treasury argued that the capital treatment of all OTC derivatives should be proportionate to reflect the risk posed to the financial system. They added that the Basel Risk Management and Monitoring Group³³ was considering this issue and that they expected capital treatment for non-centrally cleared trades to be raised above current levels (p 2).
96. In his letter to us, the Minister made it clear that the Commission’s proposal to increase capital charges for non-centrally cleared contracts was in line with the September 2009 G20 Communiqué which agreed that non-centrally cleared contracts should be subject to higher capital requirements than those which are cleared centrally (p 16).
97. **It is important that bespoke products are appropriately risk-managed though the use of capital charges proportionate to risk. The Government may wish to encourage the Commission to impose proportionate levels of capital charges in connection with the trading of non-standardised derivatives. Disproportionate levels of capital charges for non-standardised derivatives could discourage innovation**

³³ This Group issues guidelines on the appropriate treatment of a bank’s assets, including derivatives.

or, at worst, force products through central clearing which are both destabilising to, and unsuitable for, CCPs.

The effect on non-financial businesses

98. Many non-standardised contracts involve parties who are not financial institutions and who need to hedge specific exposures. We heard concerns that such businesses might be disadvantaged by the requirement to post additional collateral in relation to their non-standardised contracts. Increased charges through clearing of products, or increased capital charges on non-centrally cleared products, could discourage the use of derivatives to hedge against risk and so damage non-financial businesses.

BOX 8

Non-financial institutions use of derivatives

Non-financial institutions that use OTC derivatives to hedge physical positions such as fuel costs can be argued to be inherently less risky counter-parties than financial speculators that do not have offsetting physical positions. If an airline, for example, purchases fuel in the forward or futures market, it would incur a loss on the derivatives transactions if prices fall. However, in this case, its business profits can be expected to be higher as a result of lower fuel costs. Ignoring the implicit hedge associated with physical positions of non-financial OTC derivatives users such as utilities or transport businesses when calculating margins would overestimate the counter-party risk. To the extent that derivatives are used by non-financial businesses to hedge cash flows from their business operations, margin requirements may lead to cash outlays that are not perfectly matched by cash flows from business operations.

99. British Airways argued that the “effect of the requirement to provide cash collateral / margining is to convert the primary risk for companies from that associated with counterparty exposure into liquidity risk”. This would reduce the level of funds that could be allocated to “productive investment” and damage the ability of companies to hedge risk. They concluded the requirements posed “some threat to the continuation of *bona fide* risk management activity” (p 69).
100. The Association of Corporate Treasurers (ACT) agreed that any such requirements “would introduce new and significant cash flow risks during the life of the contract... this would be damaging to individual companies and the wider economy.” They argued that “any requirements for mandatory margining should not apply to non-financial companies” (p 57).
101. When we put these arguments to the Minister, he told us all businesses have an interest in the viability of the system “and one way or another they are going to pay for that, either through CCP margin calls or some other mechanism which might be built into the contract” (Q 35). The Minister later made it clear that “the expectation is that non-financial corporates will not have to post initial margin payments”, but noted this would not prevent participants in derivatives markets requiring initial margin payments should they chose to do so. He concluded that the increased cost of capital for financial firms will mean that “the cost of hedging risk through derivatives is likely to rise for non-financial corporates”. As proposals will ensure that

charges are proportionate to risk, “this implies that, as a generalisation, the price of counterparty credit risk has historically been under priced” (p 16).

102. ISDA, on the other hand, agreed with ACT and BA that requiring businesses to post collateral (either by clearing products or through increased capital charges) would “tie up capital that they could use providing jobs, building factories” and impede tailor-made hedging solutions (Q 70).
103. The Commission agreed with witnesses that corporate businesses were not generally systemically important. However, some engaged so substantially in the derivatives market that their default would have a knock-on effect on the financial system. They concluded that “systemically relevant institutions, whatever the label characterising them, should not be exempt from the mandatory clearing requirement.” The Commission confirmed they would be looking at these aspects in their Impact Assessment (p 87).
104. It is clear that the issue of the effect of the proposals on non-financial businesses is important, given the economic worth of derivative contracts to these businesses. **Non-financial businesses use derivatives for the purpose of risk management but these derivatives are inherently less risky as they are closely related to underlying assets. The Commission proposals could have the effect of adversely penalising the use of this type of derivative. We welcome the Commission’s confirmation that the effect any proposals would have on non-financial end-users of derivatives will be considered in the Impact Assessment.**
105. Although the Minister could not provide exact figures for the increased costs caused by clearing contracts centrally, in his evidence to us he outlined the costs of using specific CCPs to clear products. He noted that these costs were levied by the clearing house on their clearing members, and then typically passed on to the members’ clients (the end-user):
 - Some clearing houses did not charge per transaction. LCH Swaps Clear charged high volume users £750,000 per annum and lower volume users £250,000 per annum plus a monthly maintenance fee.
 - ICE Clear Europe did charge a fee per CDS transaction. This fee varied depending on the type of CDS and was either €4 or \$10 per million of underlying notional asset. For example the fee for a trade charged at the lower rate, with a notional underlying value of €10 million, would be €40.
106. The Minister noted that J.P. Morgan estimated that central clearing of standardised OTC contracts would have led to a decline of 0.7% in the earnings of businesses that used derivatives, taking into account to infrastructure and expenditure costs of clearing (pp 15–6).

CHAPTER 5: THE EU REGULATION OF CCP CLEARING HOUSES

What does the Commission propose?

107. The Commission intends to propose legislation governing the activities of CCPs “so as to eliminate any discrepancies among national legislations and ensure safety, soundness and proper governance”. This legislation would cover the following areas:
- Minimum standards for risk management, conduct of business and governance, including addressing conflicts of interest and transparency of risks and procedures.
 - Authorisation for CCPs to operate in the EU, to be granted by ESMA. ESMA may be granted direct supervisory powers over CCPs.
 - Recognition of third country CCPs by ESMA, based on criteria including comparable supervision and regulation in the third countries in which the CCPs are based.
 - Legal protection to collateral and positions, including segregation of assets and portability of client assets and positions.

Proposals for legislation on CCP minimum standards

108. The proposal to set minimum standards for CCPs at an EU level received support from our witnesses. Most witnesses agreed that globally developed minimum standards should be applied at an EU level (FOA, p 88, Deutsche Bank, p 83, Investment Management Association, p 104, Managed Funds Association, pp 112). There was, however, disagreement over what such minimum standards should involve.
109. The International Swaps and Derivatives Association (ISDA) agreed that the EU should implement global standards. They noted that global standards were important to avoid regulatory arbitrage in a highly mobile market (QQ 76–78). Deutsche Bank argued that EU minimum standards would increase the confidence of market participants in CCPs’ operational standards (p 83).
110. The Government supported “high global standards” for CCPs and noted that the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) were undertaking an international review of the operational and prudential standards for CCPs. Once agreed, these standards should be “consistently applied across EU jurisdiction” (QQ 2–5). They said that minimum standards for CCPs in EU legislation would have the benefit of both promoting a single market for CCPs and ensuring that EU CCPs were run to high prudential and operational standards. High standards for CCPs were necessary given their “increasing systemic importance” (Q 5). They emphasised that minimum standards should focus upon three areas: prudential requirements, including margin requirements; operational requirements, including robust corporate governance arrangements, management of conflicts of interest and business continuity; and conduct of business rules, including disclosure requirements (Q 42).

111. LCH.Clearnet agreed with other witnesses that minimum standards for CCPs were appropriate, but argued they were likely to be “very broad in nature” and “it would be a mistake” to legislate on specific calculations conducted by the CCP, including the level of margin a CCP should call from its clients, which should be determined by the clearing house itself (Q 121).
112. The Commission noted in its second Communication that the derivatives market was global. It stated “the Commission intends to further develop the technical details in cooperation with its G20 partners, the Financial Stability Board, and in particular with the US.”
113. Minimum standards for CCPs have the potential both to raise the operational performance of CCPs and to facilitate the single market through removing regulatory differences. This in turn will increase the confidence of market participants in CCPs and further encourage their use. We encourage the Government to support minimum standards for CCPs through EU legislation. **We welcome the Commission’s acknowledgement of the need to develop a coordinated global approach in line with the work of CPSS and IOSCO. We also recommend that the Commission’s Impact Assessment should examine in detail where minimum standards are appropriate and whether specific calculations on risk and margins are best left to the clearing house itself.** We intend to return to these requirements when we come to scrutinise the specific proposals.

Supervision of CCPs

114. While it was generally agreed amongst witnesses that the EU was the correct level for regulation of minimum standards for CCPs, most witnesses did not believe this was the correct level for their supervision. The second Communication argued that ESMA should authorise CCPs and raised the possibility of supervision also being undertaken by ESMA, given the cross-border nature of some CCPs.
115. The Government disagreed. They told us that “as the Commission or a pan-European regulatory body cannot bear the fiscal responsibility in the event of a failure of the CCP, supervisory responsibility and authorisation should therefore remain with the competent home authority.” They added “if you are supervising a CCP, then you should be authorising it” (Q 52). In his letter to the Committee, the Minister told us that at the moment no pan-European body would have the funds to bear the fiscal responsibility in the event of the failure of a UK CCP (p 17).
116. ISDA acknowledged that “you could in theory gain greater backing for any bailout of a CCP by broadening the scope of the funds available to do that”. However, “in practical terms, that would not seem to be a realistic option” and “the logic of national supervision seems hard to avoid” (Q 79). The Futures and Options Association (FOA) noted that having ESMA authorising CCPs, but national authorities supervising them, would “create needless conflict, duplication and confusion” (p 90). They agreed with the HMT/FSA paper that “it is unclear what additional benefits the introduction of authorisation and supervision at a pan-European level ... can deliver.”³⁴

³⁴ HMT/ FSA, *OTC Derivatives*, p. 15.

117. As with other aspects of the financial system,³⁵ cross-border supervision by an EU-wide body such as CCPs has some attractions. However, the political reality is that the cost of any failure of a financial institution, including a CCP, will be borne by the government of the Member State in which the CCP is situated. **We recognise that the absence of any cross-border fiscal burden-sharing arrangements for failing financial institutions means that supervision of CCPs at EU level is probably unrealistic. It may be appropriate to develop a supervisory system at EU level along the lines of that currently under negotiation for EU banking supervision, in which supervisory best practice is shared and technical standards defined.**³⁶

Separation of collateral

118. The Communication calls for legal protection for collateral provided by clearing members' counterparties. This is relevant because in the event of the collapse of a clearing house or a counterparty, unless collateral is separated from the other assets of the clearing house, counterparties may not be able to retrieve it, worsening a crisis by reducing liquidity. This is explained in detail in Box 9.

BOX 9

Lehman Brothers' involvement in OTC derivatives and financial crisis

Lehman Brothers was a counterparty to many OTC derivative transactions. The clearing of these transactions can be considered a success since the margins provided by different counterparties were sufficient to close out the positions after the default of Lehman Brothers. However, an unexpected adverse consequence arose because of the lack of segregation of collateral payments provided by Lehman clients from those of Lehman's other assets.

Some financial institutions such as hedge funds used Lehman Brothers as a prime broker and provided it with margin and collateral payments. To reduce funding costs, these clients did not insist on the segregation of these payments from other Lehman assets. From the investment bank's perspective, not segregating these payments gave it the ability to use the collateral to fund further business activity, a process called rehypothecation.

After the Lehman bankruptcy, some funds were unable to reclaim assets they had posted against derivatives and other trades because the collateral had been reused in the bank's other businesses, including in the UK, and was blocked in bankruptcy proceedings. Several hedge funds suffered a liquidity crisis due to their inability to close positions entered with or through Lehman. This liquidity crisis coincided with redemptions by hedge fund investors.

As a result hedge funds were forced to pull capital from other still healthy investment banks to meet investor redemptions. Since many of these still healthy investment banks were heavily reliant on wholesale funding,³⁷ these in turn suffered a liquidity crisis.

³⁵ The reports European Union Committee, 14th Report (2008–9), *The future of EU financial regulation and supervision* (HL Paper 106) and 3rd Report (2009–10), *Directive on Alternative Investment Fund Managers* (HL Paper 48) discuss the proposals for EU supervision of banking and investment funds.

³⁶ The Committee discussed proposals for EU supervision of banking in a letter to Lord Myners of 25 November 2009: EU Sub-Committee A, *Correspondence with Ministers*: <http://www.parliament.uk/hleua>

³⁷ Wholesale funding is a method that banks use in addition to core demand deposits to finance operations and manage risk.

119. The MFA described the protection of customer positions and collateral as “absolutely critical” and urged the Commission to bring forward rules separating the initial margin posted by counterparties from the assets of the swap dealer. They explained that such requirements would have lessened the knock-on effect of the failure of Lehman Brothers (p 112). LCH.Clearnet explained that after the collapse of Lehman Brothers, counterparties were “not able to retrieve, on a timely basis at least, the collateral locked up as part of the whole administrative process of Lehman Brothers.” This would in turn make it difficult “to disentangle a specific client’s collateral and transfer it, together with the related contractual obligations, to another (solvent) clearing member.” They agreed that collateral should be separated from other assets in the EU legislation, but noted they were “confident” the continuing consultation process would lead to a more satisfactory structure (Q 111 and p 49).
120. **The separation of collateral from clearing houses’ other assets can help maintain liquidity in a crisis. We agree with the Commission that proposals to include specific requirements for separation of assets are attractive.** We intend to scrutinise such requirements in detail when we examine the specific proposals.

CCP competition

121. CCP clearing houses are privately owned entities, and as such their location and number are subject to market forces. Competition between clearing houses is relevant to the quality of risk management that they offer, as the parties in a derivatives contract choose which to use. One clearing house may attempt to offer lower margins than a competitor to attract custom, but to the detriment of risk management. The Minister told us that 20 CCPs currently operate within the EU, but many of these are local in scale (Q 38).
122. Commenting on this issue, LCH.Clearnet told us that larger clearing houses are able to offer lower margins because a large portfolio allows more opportunities to offset risks (Q 122). They argued that “the most desirable outcome of that would be to have clearing as a highly concentrated activity, because the fewer clearing houses there are the more benefit from this offsetting and netting you get” (Q 104). ISDA agreed that “the more you can put in one place the more efficient the margining,” but noted that having fewer CCPs concentrated risk. They told us that they were currently encouraging multiple CCPs, but expected to see industry consolidation in the next five years (Q 84). The Commission agreed that “competition between market infrastructures would most likely have an effect on the future market landscape” (p 88).
123. The Minister noted that while appropriate prudential and operating standards in Europe were necessary to avoid a “race to the bottom in terms of risk management”, market forces should determine the number of CCPs. He agreed with ISDA and the Commission in envisaging activity focusing around two or three CCPs in Europe in the future (Q 38).
124. The competition between CCPs also reinforces the need for appropriate regulation and supervision of risk management standards. **Supervision will be more effective if it ensures that CCPs compete on quality of service, rather than size of margins.**

Systemic risk

125. Concerns have been raised that, if the role of CCPs is increased through increasing the number and proportion of contracts they clear, they will themselves become systemically significant, and that their collapse would pose a significant risk to the stability of the market as a whole. The Minister acknowledged the increasing reliance on CCPs for financial stability and noted that this made effective regulation and supervision increasingly important and noted that a CCP could collapse if there was an “extraordinary movement in prices” which left several counterparties with losses beyond existing liquidity and capital (QQ 50 and 58). LCH.Clearnet agreed that a CCP might collapse if it had “seriously miscalculated the level of risk that it had in its portfolio” and was unable to close defaulting counterparties’ positions (Q 132).
126. ISDA argued that “any time you focus that many financial trades through one entity, at some point it is just going to be so large and it is going to be handling such a high percentage of trades that it just, by virtue of its size, becomes systemically significant.” Increasing systemic importance of CCPs “could create the next problem potentially” (QQ 71 and 74).
127. ISDA told us that some CCPs have examined the possibility of central banks providing liquidity lines. We asked LCH.Clearnet whether they believed CCPs should have access to central bank liquidity in the event of a crisis of liquidity at the CCP. They noted that there were times when central bank liquidity would be “beneficial” during a crisis. However, Roger Liddell, CEO of LCH.Clearnet, commented that personally he believed businesses should never rely on the central bank providing liquidity as a last resort, because of the moral hazard issues this raised. The business models of businesses should assume that they would receive no support in the event of a crisis (QQ 137–9).
128. **Increasing the role of CCPs in the derivatives market increases their effect on market stability. If the number of CCPs operating in Europe falls in the future, as predicted by witnesses, this will also have the effect of increasing the systemic importance of the CCPs that remain. We agree with the Minister that this reinforces the importance of effective regulation and supervision of CCPs.**

CHAPTER 6: SUMMARY OF CONCLUSIONS

129. We recommend that the Government should invite the Commission to explain in detail which contracts will be covered by the definition of derivatives used in its proposed regulation, and clarify the scope of, and exemptions from, the regulation (para 14).

Derivatives: benefits and risks

130. Derivatives have sound economic and commercial benefits, and have been and remain necessary to the development of trade and commerce, but the manner in which they are used can pose a risk to the system (para 27).
131. Derivatives have an important economic function, namely redistribution of risk, but some forms of derivatives can be used as tools for speculation by participants in the financial market who have ownership of the underlying asset. Coupled with a lack of transparency in the market, where build-ups in risk cannot be detected by actors or supervisors, derivatives could help destabilise the financial system, particularly if there is a significant shift in the value of underlying assets (para 40).

Trade repositories

132. We agree with the future policy actions suggested by the Commission to increase transparency in the OTC derivative markets by supporting the use of trade repositories to record OTC derivatives contracts to ensure all trades in the market are reported. Trade repositories should enhance market transparency for regulators and reduce systemic risk by ensuring that supervisors have a comprehensive picture of market concentrations and exposure within a given asset class and allow supervisors to more accurately identify the misuse of derivatives. Further consideration should be given to access to data held by trade repositories (para 50).
133. Whilst the regulatory framework for trade repositories should be at the EU level and reflect globally agreed standards, further consideration should be given to the appropriate level of supervision within the EU (para 57).

Standardisation and central counterparty clearing of OTC derivatives contracts

134. We welcome Commission and industry efforts to encourage standardisation in derivatives products. We agree with the Government and the Commission that standardised contracts can help improve transparency and stability in the OTC derivatives markets. However we note that not all products can be standardised and that room must be left, in an efficient market, for bespoke derivatives that meet the specific needs of corporates (para 62).
135. We welcome the approach of the Commission in looking at ways to increase the proportion of contracts centrally cleared in order to reduce systemic risk. However, as the Commission recognises, central clearing is not a feasible option for all investors and all contracts. Increased use of CCPs should increase transparency in the sector by providing centralised locations for data on overall market positions, by ensuring that all derivatives contracts are reported and by enabling a clearer view of the total net amount owed on derivatives contracts (para 74).

136. We agree that standardisation should not lead to compulsory CCP clearing eligibility. Similarly, a lack of standardisation should not necessarily indicate clearing ineligibility (para 83).
137. The Government should encourage the Commission to define carefully in the final proposal which contracts should be regarded as both standardised and appropriate for central clearing. CCPs should not be allowed to clear a product if they are not prepared to manage the risk. CCPs are privately owned companies, which can currently refuse to clear products where they feel they cannot manage the associated risk and this system has worked well even during the financial crisis (para 84).
138. Increased standardisation and central clearing of OTC derivatives can increase transparency and stability. However, not all products, nor all standardised products, are suitable for central clearing. Legislation should avoid forcing these products through central clearing as this may increase risk in the system if a CCP cannot effectively manage the risk associated with a product (para 90).
139. It is important that bespoke products are appropriately risk-managed through the use of capital charges proportionate to risk. The Government may wish to encourage the Commission to impose proportionate levels of capital charges in connection with the trading of non-standardised derivatives. Disproportionate levels of capital charges for non-standardised derivatives could discourage innovation or, at worst, force products through central clearing which are both destabilising to, and unsuitable for, CCPs (para 97).
140. Non-financial businesses use derivatives for the purpose of risk management but these derivatives are inherently less risky as they are closely related to underlying assets. The Commission proposals could have the effect of adversely penalising the use of this type of derivative. We welcome the Commission's confirmation that the effect any proposals would have on non-financial end-users of derivatives will be considered in the Impact Assessment (para 104).

The EU regulation of CCP clearing houses

141. We welcome the Commission's acknowledgement of the need to develop a coordinated global approach in line with the work of CPSS and IOSCO. We also recommend that the Commission's Impact Assessment should examine in detail where minimum standards are appropriate and whether specific calculations on risk and margins are best left to the clearing house itself (para 113).
142. We recognise that the absence of any cross-border fiscal burden-sharing arrangements for failing financial institutions means that supervision of CCPs at EU level is probably unrealistic. It may be appropriate to develop a supervisory system at EU level along the lines of that currently under negotiation for EU banking supervision, in which supervisory best practice is shared and technical standards defined (para 117).
143. The separation of collateral from clearing houses' other assets can help maintain liquidity in a crisis. We agree with the Commission that proposals to include specific requirements for separation of assets are attractive (para 120).

144. Supervision will be more effective if it ensures that CCPs compete on quality of service, rather than size of margins (para 124).
145. Increasing the role of CCPs in the derivatives market increases their effect on market stability. If the number of CCPs operating in Europe falls in the future, as predicted by witnesses, this will also have the effect of increasing the systemic importance of the CCPs that remain. We agree with the Minister that this reinforces the importance of effective regulation and supervision of CCPs (para 128).

APPENDIX 1: EU SUB-COMMITTEE A (ECONOMIC AND FINANCIAL AFFAIRS, AND INTERNATIONAL TRADE)

The members of the Sub-Committee who conducted this inquiry were:

Lord Browne of Madingley
 Baroness Cohen of Pimlico (Chairman)
 Lord Haskins
 Baroness Hooper
 Lord Jordan
 Baroness Maddock
 Lord Marlesford
 Lord Moser
 Baroness Northover
 Lord Trefgarne
 Lord Trimble
 Lord Woolmer of Leeds

Declaration of Interests

Lord Browne of Madingley
Member, Deutsche Bank Advisory Board for Climate Change
Member, Brevan Howard Advisory Board
Managing Partner and Managing Director, Riverstone LLP
Member, PCCW Group of Advisors
Member, Schlumberger Business Consulting Advisory Group
Chairman, Accenture Energy Advisory Board

Baroness Cohen of Pimlico
Non-executive Director, London Stock exchange plc
Vice Chairman of Borsa Italiana SA (Borsa Italiana has a subsidiary company, CC&G, which is a clearing house for everything traded by the Borsa Italiana, and also for EDX derivatives based in London)
Non-executive Director, Management Consulting Group plc
Chairman, Trillium Partners Ltd

Lord Haskins
Non-executive Director, JSR Farms Ltd
Director, Quarryside Farms Ltd

Baroness Hooper
Chairman, Advisory Committee of three Barclays Infrastructure Funds

Lord Jordan
Chairman, Homes and Communities Agency Pension Scheme

Baroness Maddock
Non-executive Director, IDEX Energy UK Ltd

Lord Marlesford
Adviser, Board of John Swire and Sons
Adviser, Sit Investment Associates (Minneapolis)
Non-executive Director, Gavekal Research (Hong Kong)
Owner of agricultural estate in Suffolk, including residential and commercial properties

Lord Moser
No relevant interests

Baroness Northover

No relevant interests

Lord Trefgarne

Director and Shareholder, Scotty Group Plc—A UK AIM listed company in the telecoms section

Lord Trimble

Non-executive Director, CRC Capital Release Fund plc

Lord Woolmer of Leeds

No relevant interests

A full list of registered interests of Members of the House of Lords can be found at <http://pubs1.tso.parliament.uk/pa/ld/ldreg/reg01.htm>

APPENDIX 2: LIST OF WITNESSES

The following witnesses gave evidence. Those marked ** gave both oral and written evidence.

- Argus Media
- Ashurst LLP
- Association of Corporate Treasurers (ACT)
- Association for Financial Markets in Europe (AFME), British Bankers Association (BBA) and International Swaps and Derivatives Association (ISDA)
- British Airways
- Mr John Chapman
- Chatham Financial
- City of London Corporation
- Deutsche Bank
- Eurelectric
- European Commission
- Financial Services Authority (FSA)
- Futures and Options Association
- ** HM Treasury
- ICAP
- ** International Swaps and Derivatives Association (ISDA)
- Investment Management Association (IMA)
- J.P. Morgan
- ** LCH.Clearnet
- Managed Funds Association
- MarketAxess Holdings Inc.
- Dr Chiara Oldani, University of Viterbo, Italy
- Mr Antonio Sáinz Vicuña
- Wholesale Markets Brokers' Association and the London Energy Brokers' Association

APPENDIX 3: CALL FOR EVIDENCE

Call for Evidence

EU Sub-Committee A, chaired by Baroness Cohen of Pimlico, is conducting an inquiry into the European Commission's communications on ensuring efficient, safe and sound derivatives markets (COM (2009) 332 and COM (2009) 563). We invite you to contribute evidence to this inquiry.

These communications outline proposals to reform the supervision of derivatives markets in the European Union. It is expected that legislative proposals will be brought forward in stages in 2010.

The aim of our inquiry is to provide an opinion on the Commission's communications and to scrutinise the Government's policy on this issue, with a view to informing the debate surrounding the proposals for regulation of derivatives markets.

Particular questions raised by the Commission's communications to which we invite you to respond are as follows (there is no need for individual submissions to deal with all of the issues):

Derivatives

- What economic benefits do derivatives bring?
- What risks are associated with derivatives and derivatives markets?
- What role did derivatives play in the recent financial crisis?

Clearing Directive

The Commission intends to produce legislation regulating the activities of central counterparties (CCPs) with the objective of eliminating national regulatory discrepancies, improving risk management and creating a single European market for CCPs.

- Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?
- What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?
- Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?
- Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?

Trade Repository Directive

Central data repositories provide aggregate information of firms' positions and improve operational efficiency of Over The Counter (OTC) derivatives markets and market transparency. The communications suggest that legislation should provide a common legal framework for the operation of trade repositories. The Commission believe the European Securities and Markets Authority (ESMA) should be responsible for authorising and supervising trade repositories.

- What benefits the use of trade repositories bring both in terms of transparency and improved risk management?
- Should the EU regulate the legal framework for the operation of trade repositories?
- What provisions and rules should such regulation impose to improve regulation of trade repositories?
- Should trade repositories be supervised by ESMA or by national supervisory authorities?

Further issues

- The Commission intends to review the Market Abuse Directive and may extend its scope to capture more OTC derivatives and give regulators the power to set position limits. Will this improve the integrity of derivatives markets as intended?
- The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?
- Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?
- Are there further areas for regulation that the communications do not cover?

APPENDIX 4: GLOSSARY

ACT	Association of Corporate Treasurers
AFME	Association for Financial Markets in Europe
AIG	American Insurance Group
BA	British Airways
BBA	British Bankers' Association
BIS	Bank for International Settlements
CCP	Central Counterparty. CCP clearing is where the derivatives contract is effectively split into two contracts, one between the buyer and the CCP and the other between the seller and the CCP. The CCP keeps track of the value of the underlying asset and pays out and receives collateral from the two counterparties accordingly.
CDS	Credit Default Swaps
CESR	Committee of European Securities Regulators
CFTC	Commodity Futures Trading Commission
Collateral	Collateral are assets pledged by a party to secure a loan or other form of credit, and can be seized in event of default. Margin payments are a form of collateral specific to derivatives contracts.
CPSS	Committee on Payment and Settlement Systems
Derivative	A derivative is a financial instrument that derives its value from another financial asset, event or condition.
ESMA	European Securities and Markets Authority
EU	European Union
FOA	The Futures and Options Association
FSA	Financial Services Authority
FX	Foreign Exchange
G10	Group of Ten (G-10). The group of 11 countries that have agreed to participate in the General Arrangements to Borrow (GAB). Members are Belgium, Canada, France, Italy, Japan, the Netherlands, Switzerland the United Kingdom, the United States and the central banks of Germany and Sweden.
G20	Group of Twenty (G-20). A group consisting of the Finance Ministers and Central Bank Governors of 19 countries. Members include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, the Republic of Korea, Turkey, the United Kingdom and the United States.
Gross market values	The sums of the absolute values of all open contracts at market prices prevailing on the reporting date.
IMA	Investment Management Association

Initial margin	The collateral counterparties have to set aside at the beginning of a derivatives contract to cover their obligations under the contract.
IOSCO	International Organisation of Securities Commissions
ISDA	International Swaps and Derivatives Association
Liquidity	The ability to turn an asset readily into cash
Macro-prudential risks	Risks that affect the whole financial system
Macro-prudential supervision	The analysis of wide economic trends and imbalances and the detection of risks that these trends may pose to the financial system
MFA	Managed Funds Association
Micro-prudential risks	Risks that affect an individual firm
Micro-prudential supervision	The supervision of individual financial institutions supervision
MiFID	Markets in Financial Instruments Directive
Moral Hazard	The incentives for those involved in financial institutions benefiting from actual or expected government protection or insurance to behave less carefully (e.g. undertaking risky investments) just because of the existence of the protection or insurance
Nominal amounts outstanding	the gross nominal or notional value of all deals concluded and not yet settled on the reporting date.
NSA	Nordic Securities Association
OTC Derivatives	Over-the-counter (OTC) derivatives are contracts that are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary.
Regulation	Rules for financial institutions set down through legislation
SEC	Securities Exchange Commission
SGX	Singapore Exchange
Standardisation	The standardisation of the OTC derivatives contracts to increase comparability and transparency.
Supervision	Ensuring financial institutions adhere to regulation.
Systemic risk	The risk to the financial system posed by the default of a major player in the derivatives market.
Variation margin	The collateral that changes hands between counterparties based on the changing value of the underlying asset.

Minutes of Evidence

TAKEN BEFORE THE SELECT COMMITTEE ON THE EUROPEAN UNION
(SUB-COMMITTEE A)

TUESDAY 2 FEBRUARY 2010

Present	Haskins, L	Northover, B
	Hooper, B	Trefgarne, L
	Jordan, L	Trimble, L
	Maddock, B	Woolmer of Leeds, L (Chairman)
	Marlesford, L	

Memorandum by HM Treasury and the Financial Services Authority (FSA)

1. The FSA and HM Treasury are submitting this memorandum to the Committee as part of its inquiry into the *Commission communications on ensuring safe and sound derivatives markets*. If the Committee would like us to provide further information, we would be happy to do so.
2. We attach our joint paper, *Reforming OTC Derivative Markets—A UK perspective*, published in December 2009, which is the FSA/HM Treasury response to the Commission's policy communications.
3. In line with the September 2009 G20 communiqué, we broadly support the Commission's proposals for reforming OTC derivative markets. We recognise that these markets have exhibited weaknesses during the financial crisis, especially in relation to ineffective counterparty risk management processes and an overall lack of transparency. However, we have concerns about the emerging detail of some of the Commission's proposals, as we discuss below.
4. Given the importance of OTC markets to the UK economy (43% of the global market is located in the UK), it is essential that the UK leads the analysis of how these issues might be addressed.
5. The rest of this memo addresses the questions from the inquiry's terms of reference.

RESPONSE TO SPECIFIC QUESTIONS ASKED BY THE COMMITTEE

DERIVATIVES

- *What economic benefits do derivatives bring?*
- *What risks are associated with derivatives and derivatives markets?*
- *What role did derivatives play in the recent financial crisis?*

6 Derivatives have historically been used for hedging purposes, for example to protect both financial and non-financial firms against unforeseen currency fluctuations. Such hedging activity allows firms to disperse risks, which they are ill-equipped to manage, to other firms who can appropriately manage the inherent risks. This can reduce the cost of raising capital for firms where they have hedged their non-core business risks. The ability to manage risk more effectively can support growth and innovation in the core business, which in turn can lead to economic growth.

7. The market has developed considerably, and OTC derivatives are now widely used by a variety of participants for a range of purposes. The recent financial crisis has highlighted weaknesses in the current regulation of this market. As these weaknesses have materialised, the overall stability of financial markets has been threatened. These weaknesses include an acute sensitivity and exposure to the risk of the default of a counterparty, and an overall lack of transparency within the market—both to regulators in terms of information on underlying positions but also to market participants.

CLEARING DIRECTIVE

- *Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?*
- *What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?*

- *Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?*

8. We believe that there is a need for a harmonised regulatory framework for CCPs¹. In addition to providing a set of harmonised standards for the regulation of CCPs which would need to be consistently applied across Europe, an EU Directive would provide for better cross-border access. This in turn will lead to positive competitive pressures.

9. As a consequence of the proposed reforms CCPs are likely to grow in systemic importance. It will therefore be essential that the risk of a failure of a CCP is adequately mitigated. Capital, in the form of member margin-funds, a member-financed default fund and the CCP's own capital, will provide the first line of defence. However, there will remain the risk that public authorities would need to step in to provide support. As the Commission or a pan-European regulatory authority would be unable to bear the fiscal burden in the event of a failure of a CCP, we believe that primary supervisory responsibility should reside with the home state.

10. Although much of the current debate is focused on CCP clearing for standardised derivatives, we believe the availability of pricing, the degree of market liquidity and the ability of the CCP to effectively risk manage the exposure should also be considered in deciding whether or not a product is suitable for CCP clearing. Whilst we strongly support the greater use of CCP clearing for clearing eligible derivatives, we do not support proposals to mandate CCP clearing for all standardised derivatives. We believe this approach could be counter-productive and ultimately lead to greater risk in the system². We prefer an approach where regulators set extremely high and challenging targets for CCP usage (current targets are moving towards a requirement that 95% of clearing eligible business is cleared), actively monitor progress against these and take action when they are not being met.

Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?

11. In our view, the capital treatment of all OTC derivatives, whether centrally cleared and standardised or not, should be proportionate to reflect the risk posed to the financial system³. The Basel Risk Management and Monitoring Group is currently considering this issue and we expect the outcome to be that the capital treatment for non-centrally cleared trades will rise above current levels.

12. However, it is important for market participants to retain the ability to hedge bespoke risk. Therefore, there will always be a proportion of the OTC derivatives market which will not be suitable for CCP clearing. It is essential that these transactions are supported by robust and effective risk management procedures, and we are leading work for reforms in this area⁴.

TRADE REPOSITORY DIRECTIVE

- *What benefits the use of trade repositories bring both in terms of transparency and improved risk management?*
- *Should the EU regulate the legal framework for the operation of trade repositories?*
- *What provisions and rules should such regulation impose to improve regulation of trade repositories?*
- *Should trade repositories be supervised by ESMA or by national supervisory authorities?*

13. We strongly support increasing the transparency of OTC derivative markets by having more information on the underlying positions of market participants and supporting a more efficient price formation process. A trade repository can play an important role in this process. It is a piece of infrastructure which centrally collects and aggregates data on OTC derivative transactions and then disseminates the data to relevant parties. The introduction of trade repositories will be fundamental in improving transparency to regulators as they will help identify potential sources of concentration risk and market instability and will support financial stability planning. The publication of aggregate information to the market will assist with the price formation process. Industry is already making good progress in establishing trade repositories for a number of asset classes. We support this work.

14. Work is already under way at international level through the OTC Derivative Regulators forum to design appropriate reporting templates and to put in place appropriate information-sharing arrangements.

¹ *Reforming OTC Derivative Markets—A UK perspective*: Paragraphs 4.23–4.27

² *Ibid*: Paragraphs 4.5–4.9

³ *Ibid*: Paragraphs 6.6–6.14

⁴ *Ibid*: Chapter 5 “Strengthening risk management for non-cleared trades”

FURTHER ISSUES

The Commission intends to review the Market Abuse Directive and may extend its scope to capture more OTC derivatives and give regulators the power to set position limits. Will this improve the integrity of derivatives markets as intended?

15. We welcome the Commission's intention to review the Market Abuse Directive (MAD). We would welcome an amendment to include Credit Default Swaps (CDS) as a financial instrument that falls within the scope of the Directive because traders who have access to information about the financial position of the issuer of a reference asset may find it more profitable to trade in the CDS market. As trading in CDS may be more liquid and less transparent, it could provide greater scope for concealing abusive activities.

16. We would not support the MAD regime being extended to encompass physical commodity markets. However, we recognise that there may be merit in exploring the potential for creating a separate anti-abuse regime covering physical markets, outside the scope of financial services regulation.

17. We are in favour of all policy measures that are designed to prevent manipulative behaviour in derivatives⁵. However, we have not seen evidence that a blanket approach through specific position limits is the most effective way to monitor, detect and deter manipulative behaviours in derivative markets, whether they are on-exchange or OTC. In our view a broader position management approach which does not focus on one type of participant is the most effective approach to ensuring integrity in derivative markets.

The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?

18. As noted above, a certain proportion of the market will never be suitable for central clearing. It is essential that these transactions are subject to robust and transparent risk management procedures so that the failure of a major counterparty does not cause a market failure.

19. We support risk-proportionate capital charges for bilateral counterparty exposures in order to motivate firms to adopt the identified best practices associated with bilateral collateralisation arrangements⁶. There may be some non-systemic, non-financial users of derivatives which would not be able to post collateral. This is because they do not have access to the type of credit facilities that would be necessary to raise the funds required. Although we are encouraging industry to make improvements to its approach to bilateral collateralisation, we recognise there may not be a "one-size fits all" solution. We are therefore considering whether we should pursue an alternative counterparty risk management approach for these types of derivatives users⁷.

Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?

20. OTC derivatives markets are global. It is essential that regulatory responses are co-ordinated and consistently applied across all jurisdictions in order to limit the scope for regulatory arbitrage. We are actively engaged with a wide variety of work-streams both at the European and international level. It is vital that legislators take into account the considerable work which is already under way in order not to duplicate efforts. One significant area of possible disparity relates to the mandatory use of exchanges being promulgated more strongly in the US than in Europe⁸.

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Examination of Witnesses

Witnesses: LORD MYNERS, a Member of the House, Financial Services Secretary, and MR GARY ROBERTS, Head of Financial Services Strategy, HM Treasury, examined.

Q1 Chairman: Good morning, Lord Myners.

Lord Myners: Good morning.

Chairman: It is always a great pleasure to have you before the Sub-Committee. Thank you so much for sparing your time. Before we make further progress could I tell you that you should have in front of you

a list of members' interests. Baroness Cohen has asked me to declare on her behalf that in her role as non-executive director of the London Stock Exchange the subsidiary Borsa Italiana has a subsidiary company, CC&G, which is a clearing house for everything traded by Borsa Italiana and

⁵ Ibid: Chapter 9 "Position limits"

⁶ Ibid: Chapter 5 "Strengthening risk management for non-cleared trades"

⁷ Ibid: Paragraph 4.22

⁸ Ibid: Chapter 8 "The role of organised trading platforms"

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also for EDX derivatives based in London, and she would like that reading into the record. Lord Trimble also wanted to declare, appropriately, a futures interest.

Lord Trimble: This week I am becoming a non-executive director of a company called CRC Capital Release Fund, which is linked to a hedge fund called CRC.

Q2 Chairman: Lord Myners, would you like to introduce your colleague and if there is anything you would like to say by of opening remarks please do.

Lord Myners: Thank you very much. Good morning, my Lord Chairman. I am Lord Myners. I am the Financial Services Secretary in the Treasury and with me is a Treasury official, Mr Gary Roberts, who is particularly focused on matters relating to regulation and Europe. Perhaps I can just say by way of background that in October 2009 the European Commission published a communication on OTC derivatives markets with a view to developing measures to enhance the transparency and resilience of these markets. These measures included mandatory clearing of standardised derivatives, mandatory reporting of OTC derivative transactions to trade repositories, the role of trade repositories, including regulation and the reporting requirements, requirements for bilateral clearing, including capital requirements for non-standardised and non-CCP cleared contracts, and standardised contracts on organised trading venues under MiFID. The Government is generally supportive of the central thrust of the European Commission's message. We support greater standardisation of OTC derivative contracts. We support moves to achieve consistent and high global standards for central counterparties, greater use of CCPs for clearing eligible derivatives, capital charges to reflect appropriately the risks posed to the financial system and registration of all relevant OTC derivative trades in a trade repository. However, we do have some concerns regarding the detail of some of the Commission's proposals. For example, at this stage we do not see the need for mandating trading of standardised derivatives on organised trading platforms. Finally, I think it is important to note that OTC derivative markets are global in nature. They have become a very significant part of the infrastructure of financial markets but they themselves were not the central cause of the global financial crisis. Derivatives undoubtedly played a role. They enabled some of the strategies that were adopted but it is difficult to argue that the financial crisis was caused by derivatives.

Q3 Baroness Northover: Could I ask for one clarification. In terms of your concerns, could you say again what your first concern is and why?

Lord Myners: We have concerns about some of the emerging detail of the Commission's proposals. For example, we do not see a need for mandating trading of standardised derivatives on organised trading platforms. We see considerable advantage in CCPs, an absolute critical requirement for repositories which will provide a central database of outstanding contracts, but we are not persuaded that mandated trading of standardised derivatives on organised trading platforms is necessary.

Q4 Chairman: You have foreseen some of the questions and I am sure, with your indulgence, we will go further into those.

Lord Myners: Thank you, my Lord Chairman.

Q5 Chairman: What is the appropriate sphere of action on derivatives markets? Should regulation ideally or perhaps practically take place at national, EU or global level, and what are the advantages and disadvantages of regulation at an EU level on OTC derivatives markets?

Lord Myners: OTC derivatives markets are global. It is therefore essential that regulatory responses are co-ordinated and consistently applied across all jurisdictions in order to limit the scope for regulatory arbitrage. CPSS/IOSCO is currently undertaking an international review of the operational and prudential standards for central clearing parties. It is important that these standards, once agreed, are consistently applied across EU jurisdictions. It is also essential that appropriate information sharing arrangements between the appropriate authorities are in place. However, it is the Government's belief that responsibility for authorisation and supervision of CCPs should remain at the national level. CCPs will be of increasing systemic importance and a failure brings with it the possibility that public authorities would need to step in to provide support, and I think the Committee will be familiar with the Government's thinking on this issue, that where there is a risk of a fiscal charge then that risk must relate to entities, organisations and arrangements which fall within the ambit of national regulatory authorities rather than European or some other grouping, but we do recognise that the global nature of derivatives creates a need for a harmonised approach. On the second part of your question, which was about the advantages and disadvantages of regulation at the EU level, a legislative framework at a European level would have the advantage, I believe, of promoting a single market for CCPs by providing a passporting regime for CCPs and ensuring non-discriminatory rights of access to CCPs. It would also facilitate the laying down of uniform high regulatory standards. It is essential that a European regulatory framework ensures CCPs across Europe are run to high prudential and operational standards. Developing

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EU-only standards with insufficient time, however, for further analysis could result in inappropriate standards and divergence from global standards, putting CCPs at a disadvantage. Therefore, we strongly encourage the Commission to take into account the work under way through CPSS/IOSCO to review the operational and prudential standards for CCPs, given the increasingly systemic importance of CCPs—and I think this is really quite an important new development; in my 30-odd years in the City CCPs are quite a late arrival on the scene—in managing and mitigating systemic risk and the fiscal consequences in the event of a failure. As I said earlier, we believe that the supervision of individual CCPs should remain at the national level.

Q6 Chairman: You say it can be done at a European level, it is very useful to do this at a European level, and it is important we are not out of kilter with what is happening elsewhere in the world.

Lord Myners: Yes.

Q7 Chairman: Broadly speaking, at the moment what is the position being taken elsewhere on these issues, obviously, for example, in the United States but also elsewhere in the world?

Lord Myners: Do you mind if I ask Mr Roberts to answer that?

Q8 Chairman: And is the European approach in step with what is happening elsewhere?

Mr Roberts: I think there is a degree of consistency in the sense that everyone is looking at the same issues, and there are different legislative systems across the Atlantic from the European legislative systems, but even in the work that has been undertaken in the US, where they are going ahead with certain pieces of legislation in Congress, we do not know where they will end up but, the detail will still come from whichever regulator they choose to put that detail in place, which will then hopefully be informed by international discussions in CPSS/IOSCO. As yet, therefore, the legislative timetable in the US does not worry us, that they will go off and do something which is not part of the global standard, but it is a risk in the same way that if the Commission came forward with premature proposals we could find a divergence arising there.

Q9 Lord Marlesford: Lord Myners, I thought yesterday you expressed a very helpful view and I would like to quote a few words from *Hansard* and ask you about it. You said: “Sustainable growth and strength is best achieved by moving away from esoterica and the creation of toxic instruments, which may have appealed to those of strong mathematical background but were really quite distinct from servicing the needs of the economy”. What I would

really like to get a feel for from you is to what extent do you believe that derivatives do fulfil any need of the economy?

Lord Myners: One is always alarmed when one’s words are quoted back, particularly from such a well-informed member of the opposition benches. Derivatives play a very important role in facilitating efficient business conduct and reducing the amount of capital which would otherwise be required to support a business arrangement. Put simply, the ability to hedge the cost of fuel, for a farmer to be able to forward-sell the product from his farm, provides the opportunity to significantly reduce business risk. If we can enhance derivatives by requiring them on the whole to be cleared through a central clearing party which reduces the risk of systemic failure, then that is another important step forward which I think is economically beneficial. Derivatives also provide an opportunity to increase leverage, to meet the needs of those who wish to speculate, and over the last 10 years more and more complex derivatives have been created. Lord Turner, the Chairman of the FSA, has spoken about the social usefulness or not of certain innovations in the financial sector. He has gone on to talk about whether the world is a better place for the development of CDO squares and CDO cubes, and I think he has probably concluded that it is not. I think the central thrust of my reply to you would be that derivatives are helpful to businesses, investors, users and suppliers of capital, but they can be used to increase risk and what we need to do is ensure that where they are used in a way that creates risk that risk is mitigated through collateral requirements, margin requirements and central clearing.

Q10 Lord Trimble: As has been said, the Commission’s communications advocate an increase in the use of standardised contracts. Forgive me for asking what may be a very simple and not very sensible question, but this assumes that it is possible to have a standardised contract in a market that is dominated by people tailoring their derivative to their particular needs, so is it possible to produce standardised contracts? What sort of derivatives can you have standardised contracts for, and surely it is going to be very easy for people to avoid having a standardised contract if they so wish, so there are some basic assumptions there, and if we do manage to create standardised contracts what benefits is this going to bring or what costs might it impose and will it actually reduce the risk to the financial system presented by OTC derivatives?

Lord Myners: I think the advantage of standardised contracts lies in facilitating greater comparability between products, promoting more liquid markets and enhancing price discovery. Many business and investor needs can be covered by standardised contracts. For example, a foreign exchange contract,

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an interest rate contract, a contract related to hedging fuel, ought to be able to be largely accommodated through a standardised contract. There will be other situations in which a bespoke contract is required, perhaps with some conditionality that if event A happens, then you have the options of B and C, but if event A does not happen, you have the options of D and E, and that, I think, is where the bespoke requirement arises. I think historically one of the reasons why the intermediaries have been so profitable—and I think it is a very interesting question, how those who provide financial intermediation stand between the suppliers of capital and the users of capital have been so profitable over so many years—is that they have promoted the use of bespoke contracts which contain within them costs and charges which are not immediately visible. I think that from the perspective of the user standardised contracts have considerable attraction and from my experience often in a derivative contract you are not seeking absolute risk elimination; what you are seeking is significant risk reduction and that can be achieved through standardised contracts.

Q11 Baroness Maddock: I think, my Lord Chairman, that much of what I was going to ask has been answered in Lord Myners' previous answer. You indicated in your opening remarks that the Government did not think that it should be mandatory for standardised derivatives to be centrally cleared and you have now indicated that you can see that there is a place for having standardised contracts. Can you perhaps indicate how one could encourage that to happen?

Lord Myners: I think there is a very complex trade-off here, from the perspective of managing systemic risk and also, I would argue, delivering value to the end user, between whether we should be seeking to encourage standardised contracts and central clearing, but on the other hand we do not want to inhibit innovation or make it more difficult for businesses or investors to secure the precise risk reduction that they wish to establish through a derivative contract. Therefore, when we put capital requirements behind CCP contracts versus capital requirements to support a bilateral bespoke contract we must seek to ensure that we do not end up with an outcome which would either continue to encourage the use of off-market, non-cleared, non-standardised contracts on the one hand or to make it so penal to not use a standardised contract that we would make it very difficult for business and investors to secure the risk reduction which a derivative could provide, providing the terms were not excessive in terms of collateral or capital. We end up, I think, with a situation where incentivisation might include higher capital charges for non-CCP cleared trades, increased use of bilateral collateralisation for non-CCP cleared

trades and an approach whereby regulators set extremely high and challenging targets for CCP usage and actively monitor progress against these and take action where they are not being met so that the regulators are focused on the trend in CCP cleared standardised contracts, and to the extent that they see a direction of travel which is inconsistent with their objective they should be asking questions about why standardised contracts are not able to meet this particular requirement in the market, which may, for instance, alert them to the fact that there is a need for a new form of standardised contract. Gary, is there anything you would like to add?

Mr Roberts: We talk about standardised contracts. We also need to talk about clearing eligible contracts because some of those standardised contracts will not be safe to put in a CCP. For example, it could be a standardised contract but it does not have regular availability of pricing, it does not have the depth of market liquidity, and so the ability of the CCP to effectively manage the risk is not there. CCPs will need themselves to have a view on which standardised contracts are clearing eligible and that distinction needs to be brought out.

Q12 Chairman: You are saying that some standardised derivatives might not be suitable for clearing?

Lord Myners: Yes.

Q13 Chairman: But it should not be mandatory for all derivatives to standardise, so your broad position is that with all derivatives it should not be mandatory that they are standardised, and even those that are standardised may not be suitable for putting through clearing. Is that what you said?

Lord Myners: Yes.

Q14 Chairman: I think that was what you said.

Lord Myners: Yes. I am mulling over the very last point about whether a standardised contract could not be suitable for clearing. I think there are circumstances in which that would be the case but they are likely to be quite unusual. The CCP is going to become a very important feature of the landscape and we must make sure that the CCP is subject to appropriate regulation, governance, has adequate capital, can manage conflicts of interest and is not likely to be broken by the impact of clearing contracts which are non-standardised and which it cannot regularly monitor price and make margin calls against. If we do that, we are undermining a very important part of the strength of the infrastructure for the financial markets going forward.

Q15 Baroness Maddock: We have had evidence from people like British Airways dealing with fluctuations in fuel prices, so do you think clearing exemptions

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should be granted to certain corporate users of derivatives, such as British Airways?

Lord Myners: I think that all users of financial markets benefit from confidence in the strength of the financial system and should be encouraged to make a contribution to that, so I would start from the disposition that an industrial user of the derivatives markets would be expected to clear or have their contracts cleared through a CCP. If they have bilateral contracts, then some issues arise as to whether the liquidity requirement of maintaining a variation margin could give rise to certain funding issues for a non-financial institution and it seems the answer would lie there with a capital cost charge that they would have to pay to address the capital that their counterparty had engaged in the contract.

Baroness Maddock: I think that is what they were concerned about.

Q16 Lord Trimble: I was just going to mention that people like BA do have to put a significant margin against the asset that they are buying in the future or have the contract in relation to, so if they are having to pay an additional charge as to the CCP for the use of it, then that is imposing a significant burden on those forms of business and I think that is something that we are going to have to take into account.

Lord Myners: Yes, of course.

Mr Roberts: The corporates are obviously very important and what we are trying to do is ensure that the financial firm using the CCP will be putting the margin up, the money into a default fund, et cetera, and then that will be suitably priced for the non-financial firm, the corporate, so the corporate themselves will not be putting up margin into the CCP. Effectively, it is much as it is now in the sense that there are already trades which the corporates are entering into which are cleared. It is just that in future, as those contracts become standardised and get over the hurdle of being clearing eligible, they will go into the CCP, and then the appropriate pricing of the risk, will then apply to the contracts with the financial firm. We are not seeking to bring the corporates into the clearing. They will still be outside and the risk charge will be proportionate.

Q17 Lord Trefgarne: Would you not think, though, that the example that we are talking about of British Airways ordering fuel forward from Shell or BP, or whatever it is, is actually a transaction within the fuel business, not within the financial business, although, of course, there is a financial aspect to that, and therefore the least interference from the financial markets for such transactions the better?

Lord Myners: The contract is derived from the fuel market but, in as much as it is conducted through financial institutions, we need to ensure that the oversight of those transactions is appropriate in

order to manage both the risk to the individual institution with whom British Airways may be trading and also the broader systemic consequences.

Q18 Lord Marlesford: But is there not a danger in attempting to mutualise effectively these risks, that you actually could end up with this terrible repackaging which was part of the whole problem we ran into with the credit crunch?

Lord Myners: I do not think mutualisation is how I would describe it. What it is doing is each day adjusting payments between market participants to ensure that risk is appropriately covered, so the person who has, if you like, the wrong side of the contract in terms of market movement over the last 24 hours makes an adjustment into the CCP to cover that loss so that the structure is not undermined by the accumulation of large uncovered losses. I do not think that is mutualisation. I think it is asserting robustness into the structure that links together various participants through a central market.

Chairman: Before I turn to Baroness Hooper I think Lord Haskins has a supplementary on this point.

Q19 Lord Haskins: Just following on that, I have found, and I go into derivatives frequently, that it does not seem a very complicated business for me to buy or sell a thousand tonnes of wheat forward, so I do not see why it should be all that difficult for BA to enter into it. Surely the nub of the derivatives issue is this complication? I guess that the failure in corporate governance above all else has been non-executive directors in the banks being unable to understand all this complexity. Is there anything in all this which is going to reduce the complexity?

Lord Myners: Lord Haskins knows my great interest in this area and I will resist the temptation of rabbiting on for too long about corporate governance, although I was reading something over the weekend which reminded me of the comment made by one of the non-executives of one of our major banks to a Treasury official about year ago. "In the future", he said, "we are only going to do things we understand", which begged a huge number of questions. Hopefully, most of what I have been conveying is that I do think that far more needs can be covered by standardised contracts than is probably generally realised. I think that the pursuit of that outcome on the part of the end users and suppliers and the taker of risk and the provider of risk would be facilitated by more standardised contracts and I am inclined to believe that these things can be simpler than is generally assumed, but where that does not apply is when derivatives are used to take on risk rather than lay off risk. That is where non-executive directors would really have to be on their toes.

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Q20 Baroness Hooper: My Lords, one thing is clear to me, that this is an incredibly complex subject and it also appears to be evolving all the time, which makes it difficult for us in this inquiry to do something at great speed.

Lord Myners: Yes.

Q21 Baroness Hooper: It is therefore very tempting to see standardisation as a solution even if standardised contracts are feasible. Is there a danger, however, that attempts to increase the standardisation of contracts will increase the number of bilateral deals at the expense of the CCP clearing? I realise that you have partially covered that already. Has the Government undertaken an assessment of the proportion of different derivatives that are not centrally cleared?

Lord Myners: This is a very tricky area, and I absolutely agree with your introductory comment that this is an area which is evolving quite rapidly and I have got considerable confidence that we will end up with a much stronger structure based around the increased use of CCPs, higher quality CCPs, and increased transparency and market intelligence through the use of repositories, but it is an evolving situation. As part of an international effort to increase central clearing of derivatives, a target was set for the G15 dealers to clear 70% of new interest rate swaps by the end of 2009, along with a target of 80% for all eligible credit default swaps by October 2009. By November 2009 the average percentage of cleared interest rate swaps was 80%, varying between a low of 61% and a high of 94% for individual G15 members, and the average percentage of cleared eligible credit default swaps was 89%, which was a spread of 66% to 97%, so I think there is evidence that a significant proportion of business can be conducted through standardised contracts and that those target and achieved figures are capable of being further increased and I would generally regard that as being a beneficial outcome.

Q22 Baroness Hooper: You do not see a great danger of a move towards bilateral contracts?

Lord Myners: No. I would hold out the hope that increased use of standardised contracts and the confidence that comes with having those cleared through CCPs and increased knowledge of trading volumes and of prices will encourage people to wish to trade through standardised contracts as opposed to through specifically tailored contracts. My central assumption in reaching that conclusion is that most needs in these markets can be met through standardised contracts.

Q23 Lord Jordan: Which do you regard as the most important—standardised contracts or transparency, because we have seen all this is evolving and the

reason for the evolution is that the moment people start to understand it they then move on to something they know they will not understand?

Lord Myners: A wise question. As I said earlier, I think standardised contracts will enhance visibility and transparency. There will always be agents who will seek to suggest that a bespoke contract will even more precisely meet the requirements of the prospective purchaser or seller of the derivative trade, but my expectation is that more users will recognise that they would prefer to stay with the standardised contract which has that element of transparency and price visibility. I think transparency undoubtedly will enhance confidence in the system and facilitate use and therefore liquidity and therefore, generally speaking, more efficient pricing, and the facilitation of central clearing through standardisation will further increase confidence in the robustness of the system. Do you have anything you want to add to that, Mr Roberts?

Mr Roberts: I will just add that if it is not cleared or exchange-traded, we are still looking to see increased reporting to trade repositories, so the transparency will come in that way, so even if you do not have a standardised contract, even if you do not have one that is clearing eligible, it will still make it possible to get increased transparency through reporting.

Q24 Lord Haskins: I am trying to work out the benefits and the costs of central counterparty clearing and how it works in practice. What does that mean? What are standardised contracts? Mr Michael O'Leary of Ryanair wants to buy up the world's oil. He does not want to be delayed in that process; he wants to make immediate decisions. What is the process in terms of him going through the standardised counter clearing process and will it reduce in any way the risk that either party is taking?

Lord Myners: The airline owner in that situation, having taken a view perhaps by fixing the price of tickets in the future, will want to ensure that profitability is protected through assurance about the price of fuel and that the profit is not eroded by a sudden increase in fuel prices, will find a suitable standardised derivative contract in terms of the nature of the underlying asset (airline fuel in this particular case) and the time horizon, and, through a financial intermediary, will contract to buy forward X thousand tonnes at such-and-such a price for delivery at such-and-such a date. Of course, as they get closer to maturity of that contract, if nothing else happens they close out that contract in exchange for fiscal delivery. If the price of fuel has increased during the period, then Mr O'Leary will have a profit because he bought fuel at a lower price and he will receive a gain on his derivative contract which he will then offset against the price he has to pay for the fuel in terms of physical delivery. To the extent, however, that the

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price of fuel goes in the opposite direction and falls, then the seller of the fuel has effectively sold above the market price and Mr O'Leary will owe them money.

Q25 Lord Haskins: The answer is no?

Lord Myners: Yes.

Q26 Lord Haskins: So that is the market working?

Lord Myners: Yes.

Q27 Lord Haskins: But where does the central clearing fit into this transaction?

Lord Myners: If it is a standardised contract, the central clearing party each day will receive what generally speaking will be modest payments per contract from those who have seen the contract move against them, so a buyer of something where the price has fallen and vice versa, in order to ensure that the CCP, or those who participate through the CCP, always have funds to satisfy their obligations under contracts.

Q28 Lord Haskins: And they keep reminding them as this process goes on? They will be looking at how it develops and ringing up and saying, "Mr O'Leary, you are dangerously exposed. What are you going to do about it?"

Lord Myners: I think that may be a possibility. It would be quite a bold person who rang Mr O'Leary up to ask that sort of question. I have never met Mr O'Leary myself but his reputation travels ahead of him—

Q29 Lord Haskins: I know him.

Lord Myners: —so I approach it with some trepidation, but, yes, he might say, "Mr O'Leary, you seem to have got it wrong".

Q30 Lord Haskins: I think he would be an unwilling participant, put it that way.

Lord Myners: Yes.

Q31 Chairman: In very simple terms, it will depend on the contract, but what kind of percentage increase is the cost of obtaining, effectively, this insurance fund? What would be the kind of figure we are talking about? Say it was a £100 million contract. What are we talking about?

Lord Myners: My Lord, that would be a question that it would be better for us to revert to you on in writing because I suspect that we could give you an answer now which would be correct but in writing we can give you one which captures the full nuances of how the costs operate.

Chairman: Because in your example of a non-standardised contract that could be standardised and carry on to the full central clearing, effectively that will, for perfectly sound reasons, as you say, Lord

Myners, have a slight additional cost to it because it is ensuring that there are some funds around in the event of failure, so having an understanding in the Sub-Committee of what we are talking about here in terms of add-on costs that ensure the benefit of reassurance of the system would be helpful.

Q32 Lord Trimble: I may have misheard but I understood you to say in reply to Baroness Maddock, when she was giving the example of BA, that you did not envisage these corporates going through this system, that it was only the financial companies that would be going through it.

Lord Myners: I would welcome a comment from Mr Roberts, but the corporates would execute their transactions through a financial institution.

Mr Roberts: They would not directly be putting the collateral into the CCP. The financial institution would be doing that and, as part of the price for the contract—

Q33 Lord Trimble: A lot of corporates will have their own financial institutions.

Mr Roberts: In that case, if they act as financial institutions, then they would be—

Q34 Lord Trimble: But it will mean that there will be this cost in addition to the margin that the corporate has to put in when they are going into the future contract. There will then be an additional cost to cover whatever is incurred by the financial institution going through the CCP?

Lord Myners: I am going to imagine, and again if I misdirect the Committee on this I will drop you a line, that if British Airways is dealing in the forward fuel market, Lord Trimble, they will check their Reuters or Bloomberg screen, they will identify the contract which most closely meets their requirement, they will look at the various bids and offers quoted and they will transact with whichever financial institution offers them the best transaction at that time with whom they have a relationship. It could be, for instance, Barclays Bank, and then they would have their own arrangement with Barclays about variation payments on the contract or a capital cost requirement, but the CCP would, I believe, be bringing together financial intermediaries, authorised banks and financial institutions, rather than the end corporate user, so Lord Haskins, when he is selling his thousands of tonnes of grain, would not be a direct member of the CCP but would be trading through another party.

Q35 Chairman: Before I turn to Lord Jordan, we have had a number of corporates in written evidence saying that they do not currently pay margins on bilateral deals, but in future if they have standardised products they will have to go through clearing but

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they will have to pay a margin. Do they misunderstand how the system works, because, in fairness to British Airways, it is not just British Airways who have said this; a number of corporates have said that it will incur costs they currently do not? Are they misunderstanding what will happen?

Mr Roberts: I think they may be in the sense that we already have lots of contracts which are cleared through CCPs. What we are trying to do is encourage more contracts to be cleared. If the risk has been mis-priced in the sense that British Airways or whoever has got a contract where the price has not been properly formed and now there will be an additional cost, because the financial institution is putting up margin which they did not do when it was a bilaterally cleared contract, then, yes, there would be an increase in their costs. I think in general you will probably find that their existing bilateral contracts will have something akin to margin, possibly with some movement in the credit lines they have with financial institutions, so these costs are probably picked up in other ways currently, but we will need to look quite carefully, at the changes and how they will affect the corporates and ensure that the pricing is more correct if it was not correct in the past. You cannot give an exact answer to this; it will depend on the individual contract, but the concerns of the corporates are well understood and we are talking to them to try and overcome misunderstandings and deal with issues that might arise.

Lord Myners: It would be a perverse outcome if non-financial institutions ended up with a more favourable way of trading without bearing the cost of supporting the integrity of the system which would encourage the increasing conduct of business through non-regulated institutions. British Airways, if we keep them in the focus of our mind as one of many tens of thousands of users of derivatives, clearly have an interest in the viability and the sustainability of the system and one way or another they are going to pay for that, either through CCP margin calls or some other mechanism which might be built into the contract.

Q36 *Lord Jordan:* Lord Myners, does an analysis of costs and benefits of increased CCP clearing apply equally to all main groups active in derivatives markets? The evidence that we have been receiving suggests that this is an area where one size will not fit all. Does regulation need to be appropriately tailored to the different types of derivatives?

Lord Myners: Qualitative analysis shows that the costs and benefits of increased CCP clearing services do not apply equally to all the main groups active in derivatives markets. The benefits of moving participants onto clearing in order to reduce systemic counterparty risk are greatest for the biggest players, as the major dealers are, as the risk of failure of a

large player domino-ing across the market is far greater than for the smaller players. The costs are also different. Currently large financial players are used to the process of collateralising their trades and have access to the wholesale funding that allows the daily provision of unpredictable margin calls. Smaller participants, especially corporates, do not always have the facility to meet daily margin requirements, and accordingly some other mechanism needs to be available to them to ensure that they make their contribution towards risk mitigation. While high level principles will be common across the different types of derivatives regulation does need to account for differences in technical detail by asset class. I think, Lord Jordan, as we continue to work with the EU and other bodies and regulators in this area we must be constantly alert to the need to ensure that we do not unintentionally favour one sort of participant over another or one form of contract over another and strive, as always, to achieve the elusive level playing field.

Q37 *Lord Jordan:* In your submissions on behalf of the Government, are you going to try to ensure that those who, as you say, benefit very little from this proposed system would not be forced into it?

Lord Myners: I think that those who choose not to use standardised contracts will continue to have the facility to engage in bilateral contracts and that those who want nothing to do with derivatives, because it all looks and feels like smoke and mirrors, will continue to be able to adopt that position.

Q38 *Lord Trimble:* On the question of central CCP clearing houses, how many exist within the EU and elsewhere? Is it envisaged that the number of such clearing houses will be determined simply by market forces? Is it important that some operate in the EU and does this raise any policy issues?

Lord Myners: I was rather surprised to find that there are currently 20 CCPs operating in Europe but my officials tell me that some of those are quite localised in terms of individual national exchanges and we are not looking at a situation where there are 20 large-scale competing CCPs. Subject to appropriate prudential and operating standards which will avoid any race to the bottom in terms of risk management, market forces should determine the number of CCPs. One imagines that over a period of time for major contracts we will see the focus of activity around two or three CCPs for major contracts. As a Government, we are neutral over location of CCPs, providing that they are appropriately regulated and offer equivalent levels of protection to participants. We expect the UK, however, as one of the world's leading global financial centres to be a major host to CCPs and believe that it would enhance the UK if it was a natural centre for the location of CCPs, and to the

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extent that the Government can take action to facilitate that we will obviously be alert to the opportunities because we want to ensure that London continues to be a vibrant, successful, profitable, sound and responsible financial services centre.

Q39 Lord Trimble: I assume that some of the clearing houses specialise in certain types of trade.

Lord Myners: Correct.

Q40 Lord Trimble: And that will enhance the difficulties of the small ones that are trying to do a lot of things for a particular locality and may find themselves at a disadvantage compared to that.

Lord Myners: Yes.

Q41 Lord Trimble: But is not the essential thing here agreement worldwide about minimum standards?

Lord Myners: Yes.

Q42 Lord Trimble: How do they evolve that? How do we get to a situation where we have agreed minimum standards for the clearing houses?

Lord Myners: The agreement of minimum standards, which would relate, for instance, to prudential requirements that CCPs should impose sufficient margin requirements and that they should maintain default funds, to operational requirements such as robust corporate governance and arrangements to identify and manage conflicts of interest, to maintain business continuity policies, and finally conduct of business rules to ensure that the CCP acts fairly and professionally and makes appropriate disclosure of prices and fees, should apply to CCPs regardless of where they are based. If we look at it from the perspective of Europe, which is the focus of the work of this important Committee, a European regulatory framework would help ensure that CCPs across Europe are run to high prudential and operational standards and we are aiming to make sure that there is a common minimum standard for CCPs developed through the work of the group which I mentioned earlier under CPSS/IOSCO.

Q43 Lord Trimble: And that is going to be the vehicle which is going to evolve the world's minimum standards?

Lord Myners: Yes.

Q44 Baroness Hooper: Who actually owns the CCPs, and does this differ in different countries?

Mr Roberts: Some of the CCPs are owned by the banks. They have different shareholding arrangements.

Q45 Baroness Hooper: A combination of banks or just one bank?

Mr Roberts: A combination of banks and some are non-banks.

Lord Myners: Some are owned by exchanges.

Mr Roberts: So there is a mix around the world.

Lord Myners: And that is why, in my earlier answer to Lord Trimble when I was going through my checklist of what a CCP needed to do in order to be successful, I emphasised under operational requirements arrangements to identify and manage conflicts of interest, because, to the extent that major market participants are owners of the CCP, that can give rise to conflicts of interest and there needs to be an appropriate governance structure and an appropriate regulatory oversight to ensure that those conflicts of interest are properly managed.

Chairman: The ownership of the CCPs by banks leads us directly to Lord Marlesford.

Q46 Lord Marlesford: I must say I am beginning to feel that the Commission officials, in producing these schemes, are wildly out of their depth. I hope our Treasury officials are not as well, but, frankly, I think there is total confusion in the use of this word "standard". You can, of course, have standard contracts, but what you cannot do is standardise contracts because contracts are much more complicated than has been suggested. It is not just about, "I will sell my thousand tonnes of wheat at today's price because it is a good price to get". In the case of the hedging on air fuel, I have seen some of them and they are incredibly complicated. My worry is that any idea of commissioning which is a function of risk is totally impracticable. The terms of the contract should reflect the risk on both sides. Commission, which is in any way a function of volume, does not reflect the risk and therefore effectively is mutualising the thing. That is my worry.

Lord Myners: I suspect there is a lot of subtlety in that question which I would be able to respond to more helpfully if I could consider carefully the question and possibly write a letter to the Committee, but I think the essence is that we are talking about contracts with standard terms and it does not seem to me that that is complicated. For instance, if you are entering into a business transaction where you are going to borrow money and you are concerned that in a year's time when you come to pay interest rates may have risen, you can hedge that. You can buy cover. That seems to me to be capable of being standardised and if it happens that the contract moves in your favour then you will make a profit. If it moves against you, you will make a loss on that contract but you still will have protected yourself against the risk because effectively in that situation your cost of borrowing is likely to be lower than you had anticipated it was going to be, so I do not see an element of mutualisation. Mutualisation means to me that I have to share in somebody else's loss and I

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do not see that as being the case here at all. There are two parties to the contract and to the extent that there is a financial gain or a loss as a consequence of the maturation or the closure of that contract then that is a matter for those two parties clearing through a central system, pretty much as if I write a cheque and make it payable to you that is a bilateral contract even though it goes through a centralised clearing system. If there is more to your question that I have missed, I will absolutely study it with great care and drop the Committee a line.

Q47 Lord Marlesford: I think it is this question of removing the systemic risk; that is really my concern. That is what I think is extremely difficult to administrate. I totally agree that you can have standard contracts and all that and terms of payment and all that. That is not a problem. The real problem is the systemic risk one and that is the one which I think is extremely difficult to guard against with this sort of regulation.

Lord Myners: Of course, we all have a mutual interest in reducing or eliminating systemic risk because you do not want yourself in a situation where you feel that your knowledge of your counterparty in the contract is one which gives you complete confidence about their capacity to settle the contract but somehow the whole system would begin to become exposed and your counterparty would be undermined, so we have a shared interest in the system remaining robust, and to that extent there is a mutual interest in ensuring systemic strength. That is what the CCP is designed to achieve and, if done properly, according to those conditions on the checklist I detailed earlier on, I think we will have significantly reduced systemic risk.

Q48 Lord Trimble: Does this mean that we are pinning everything on the ability of the clearing house to tell how much risk is there in the particular circumstances day by day and manage it?

Lord Myners: Yes.

Q49 Lord Trimble: But we are putting more and more business into these clearing houses and is that not taking us into somewhat uncharted waters?

Lord Myners: Yes, but they are going to become very important parts of the architecture of the world financial system—

Q50 Lord Trimble: But if they get it wrong?

Lord Myners: —and this was brought up by the Deputy Governor of the Bank of England, who I believe has recently spoken about the absolute importance of ensuring that these CCPs are adequately capitalised and that they have good operating systems and sound management because we are going to place a lot of reliance on them. I am not sure the analogy is completely right, but it is

rather like the national grid. We are all very dependent on it for individual electricity, but generators and power stations, users, et cetera, are all brought together by the confidence that the grid will operate.

Q51 Lord Trimble: That is an easy job compared to the CCP, is it not?

Lord Myners: I am sure they are both difficult jobs.

Q52 Baroness Northover: Following on from those points, we have been discussing, not only now but also before, at what level financial supervision and regulation should be and you have made clear that you see regulation as being at an EU level and supervision at a national level because that is where these institutions have to be bailed out, but perhaps I can ask you a little bit about EU supervision and whether you think that CCPs should be supervised at a European level. Should they require authorisation by the European Securities and Markets Authority to operate, and—and you have already in some sense answered this—who will be responsible for a CCP should it collapse or require financial support? Perhaps I can link this in to the points we have just raised about how the CCPs themselves will become part of the new system and therefore potentially present new systemic risks themselves if they are, as you describe them to be, much bigger platforms, and also pick up your point that you see the UK being a major host of these and therefore the implications for the United Kingdom should they run into trouble.

Lord Myners: Let me make some introductory comments and then I would like to ask Mr Roberts if he would like to talk a little bit about the approval process for CCPs and I will also add some comment about why I think it could be attractive to us in the UK economically. It has already been recognised that supervisory responsibility for financial institutions which ultimately may need the taxpayer to stand behind them should reside with the home state; that was most recently confirmed by the European Council. As the Commission or a pan-European regulatory authority cannot bear the fiscal responsibility in the event of a failure of the CCP, supervisory responsibility and authorisation should therefore remain with the competent home authority and that will require the FSA to satisfy itself as to the probity, the capitalisation and the operational resilience of a CCP. Subject to those conditions being met, not only to meet the conditions of the FSA but also to meet the needs of the real market, that is to say, the FSA vetting process has identified all reasonable risks, then to host a CCP will undoubtedly enhance the quality of the service offering that London, Paris or Frankfurt would be able to put before financial institutions considering

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locating there. Mr Roberts, do you want to add anything?

Mr Roberts: Not really, no. If you are supervising a CCP, then you should be authorising it because you will want to check that those governance and operational standards are to the high standard you expect.

Lord Myners: And am I correct that the FSA, in the case of the UK, would be the supervisory authority?

Mr Roberts: Yes.

Q53 *Baroness Northover:* If the financial services sector is a particularly large part of the economy of a particular country, as it has been for the United Kingdom, and therefore the risk is greater, do you think that the capital requirements that the FSA would wish to build in to a CCP based here would be higher than if it was a smaller one based somewhere else?

Mr Roberts: The CCP will be subject to operational and prudential requirements. The capital requirements will be levied on the members in the sense that the financial institutions will be putting in margin and paying for the default fund, making sure that whatever is needed in terms of meeting the effect of a default in the CCP is in place, so, yes, the CCP will have capital but, the major contribution coming in to ensuring the CCP does not fall over will come from the users of the CCP.

Q54 *Baroness Northover:* Indeed, yes, but might the FSA be requiring a CCP in the United Kingdom in that circumstance to be asking those people who are trading via that CCP to have larger capital requirements, if you see what I mean?

Mr Roberts: Another international standard setter the Basel Committee is looking at what the appropriate capital charges should be for financial institutions which are not using a CCP. They may also conclude that there should be a capital charge for using a CCP as well, so there may be that international standard. It is possible that, as a result of consultation and the due process of impact assessment, the FSA would decide that there should be some additional capital charge, but I am not aware that there are any plans to do that at this stage.

Q55 *Baroness Northover:* Which would, of course, mean that people would go to other ones in other countries?

Mr Roberts: Yes. This is why it is important that we continue with this push to have global standards, that we avoid regulatory arbitrage which threatens us both for competitive and financial stability reasons.

Q56 *Chairman:* Lord Myners, you said that these central clearing bodies would become more and more important in the future.

Lord Myners: Yes.

Q57 *Chairman:* And you implied, I think, that you can see that the 20 or more in Europe could reduce over time as competition and specialisation and so on and growth have this effect. In the past the unimaginable happened in different markets. If a large counterparty fund was based in London and if it did fail, that would be of very major significance for the UK in terms of fiscal responsibility. It is the unknown unknown, is it not?

Lord Myners: Yes.

Q58 *Chairman:* What are the principal, major risks that could occur that could pose a fiscal challenge to the UK? We can no longer say the unimaginable never happens because it happened.

Lord Myners: First, on the shape of the market for CCPs, I anticipate that the most popular contracts—currencies, interest rates, bond contracts, equity contracts—will gravitate towards a small number of areas where the liquidity and market will develop. There may well be a continuing need for smaller CCPs which are dealing with very localised needs in a particular country or market, so it may well be that we will end up with more than 20 CCPs, but my expectation is that a large part of the business will be concentrated on a much smaller number. What could go wrong which could lead to a very substantial loss which might have a fiscal consequence? I think the principal one would be a very extraordinary movement in prices which left a significant number of institutions with losses which went beyond their existing capital and liquidity, so setting the tolerances for margins and the capital requirements to support contracts would be absolutely critical. What we have found is that the academic who refers to this, Nassim Taleb, who refers to black swan events which economists believe happen very rarely, was persuaded more than was previously the case that these events can occur with quite a lot of frequency, so I think setting margin requirements and capital requirements is absolutely critical to risk reduction.

Q59 *Lord Trefgarne:* We are told there is a need for a repository of information. Do you see that being within the EU or on a national basis?

Lord Myners: Is a repository a regulated entity, Mr Roberts?

Mr Roberts: The FSA has a regime that allows it to oversee trade repositories, so trade repositories can locate in the UK and they will have a registration process and a form of monitoring, but in terms of, day-to-day supervision of a trade repository, I am not sure that that is necessary as it is a database or collection point, so the important things to look at are things like data protection to ensure that the

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information can flow to the relevant regulators around the world. There is a regime in the UK which will allow them to be registered.

Lord Myners: But they are not risk takers or risk providers?

Mr Roberts: No.

Lord Myners: They are information providers, so the critical issues are transparency, accessibility, the integrity of systems and continuity arrangements to ensure that a systems failure does not suddenly plunge the market into a situation where people are no longer aware of the quantum of contracts outstanding, et cetera.

Q60 Chairman: On this point, repositories will not be and are not regulated by EU regulation? I do not mean supervision. There is no EU regulation in relation to them. That is my first question. Or, is it proposed that there be such regulation, and, on the question of access to information and transparency, to whom would the repositories' information be transparent? To the users, the supervisory body, the European regulatory and supervisory bodies, the public? To whom will the transparency be available?

Lord Myners: I am going to take the easier path with that question and leave Mr Roberts to answer the other one, if only to absolutely reassure Lord Marlesford that officials in the Treasury are absolutely on top of the complexity of these issues and he need not be at all anxious about that. The second part of your question is to whom would the repositories' database be accessible: to all market participants, speculative participants, regulators and those with an interest in the market. I think the essence of the repository has to be full visibility to facilitate informed and efficient markets.

Mr Roberts: The answer to the first part of your question is that there are plans by the Commission to bring forward proposals related to trade repositories and the idea is that they will set those standards that Lord Myners set out a few moments ago in terms of the integrity of the trade repository.

Q61 Chairman: There will be the proposed European-wide regulation but supervision will be by the home host?

Mr Roberts: I have no doubt that the Commission will propose that it will be done by ESMA on the grounds that there are very few of these trade repositories, although they may well increase, but actually the location of the trade repositories does not really matter. They do not need to be within the EU; they do not need to be within the UK. The crucial thing is that they are well run and they will provide that information to the users and to the regulators so that the transparency is there.

Q62 Lord Trefgarne: My Lord Chairman, with your permission, may I take a leaf out of Lord Marlesford's book and ask you about one of the answers you gave yesterday? I think you were answering Baroness Valentine and there was a supplementary from Lord Newby. This was about the possibility of financial institutions leaving the UK. In answer to a supplementary from Lord Newby you said, "From my own perspective, if there are people in the hedge fund community who find that the new regulatory climate is too hot, invasive or demanding in the UK and want to go elsewhere, that is their choice, but I would warn those who take them in of the menace they could represent". What did you have in mind?

Lord Myners: I think if a hedge fund or trader in another country, another jurisdiction, concluded that the regulator was making life too difficult for them, perhaps around tests of fit and proper, management of conflict of interest, required capital, and that we had lower standards in the UK than that other location, then we would see this regulatory arbitrage working in a way which would attract these people to the UK because we had very low standards. I think that would be very bad for us, so I do not think that we would want to see the flow of bad money in that direction. To the extent that an institution, say, a fund manager, was finding it difficult in some ways to operate in the way they preferred to within the FSA rules but wanted to go elsewhere, that might be at some risk to the new location to which they moved. I do not think there is anything terribly profound about it.

Chairman: The last question is from Lord Jordan.

Q63 Lord Jordan: Lord Myners, it is one of those "and finally" observations. It relates to something the Chairman said about the size of financial institutions. Evolution brings most species to an ideal size. If they overgrow, they become clumsy and accident-prone and the financial systems have shown us just how true that is. Are you going to make sure that these and others are brought down to a size at which they operate best for this country, and in particular the banks? When are they going to be taken off this bonus system steroid?

Lord Myners: Here we go again. We are going well outside OTC derivatives and European regulation. The Treasury's position is that size was not a contributory factor to financial failure, that large banks failed and so did small banks, that broad banks failed and so did narrow banks. In fact, interconnectedness is probably more of a risk than size. On the issue of bonuses, of course, there is very rarely a day when I am not called to the Chamber of the House to answer a question on bankers' bonuses. I have got two questions down this afternoon. I very much doubt if I will get away without ever more feeding into the

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issue of bonuses as well, but we have taken action on bonuses but I would repeat, and this is where I find myself on common ground with Lord Haskins, that the responsibility for managing the incentive arrangements within a bank must lie with the board of directors and the shareholders. It is not an area which Government should naturally be drawn towards unless we believe that bonus arrangements contribute to unacceptable risk, and we have taken the necessary action there together with the G20 and the FSA's new code on remuneration, but it must be a matter for the shareholders of banks. I would repeat my observations to the House last week, that if you had invested in a basket of UK bank shares 10 years ago you would have lost money; if you had been a senior executive of a UK bank or a senior trader in derivatives over those 10 years, you would have made oodles of money, and the shareholders ought to be

asking whether this was the outcome they envisaged and one which they would wish to continue.

Q64 Chairman: Lord Myners, as always, you are very generous with your time and understanding of arrows from all quarters. Is there anything you wish to add? If not, we are very grateful to you. There were one or two points where I think between ourselves we agreed that one or two notes might flow. We will try and finish our inquiry and publish by the end of March, so it would be extremely helpful, through you, Lord Myners, if they would be forthcoming.

Lord Myners: We will certainly action that immediately, and obviously we will check the transcript and if there is anything else which occurs to Mr Roberts or myself that we might be able to usefully contribute, we will include that in our written answer to the Committee as well. Thank you very much for your time.

Supplementary letter from HM Treasury

During my evidence to your Committee regarding its inquiry into derivatives on 2 February 2010 I agreed to write to supplement my evidence.

1. *Will non-financial corporates face a new cash outlay in the form of initial margin payments? What level of cash outlay may be required?*

Currently, the European Commission is not proposing to place a requirement on non-financial corporates to centrally clear their OTC derivative contracts. Neither does the Commission currently propose imposing bilateral collateralisation requirements on non-financial corporates. Therefore the expectation is that non-financial corporates will not have to post initial margin payments. Of course that could change as EU legislation develops/is negotiated. And it does not prevent the market choosing to impose margin requirements eg a financial firm might require its corporate customer to post margin when entering into derivatives contracts with it (aka bilateral collateralisation).

2. *Examples of the cost of using a central counterparty for contracting parties. What increase of costs would counterparties expect to face?*

It is difficult to calculate accurately the cost to a market participant of centrally clearing a position against the cost to the market participant of holding this position on a bilateral basis. Accurate calculations could be only provided in the knowledge of all of the following variables:

- The collateral required to be lodged with the market participant's counterparty and any capital required to be held by the market participants itself (if relevant) to support a given uncleared OTC position.
- The margin required when the equivalent position is held on a clearing house, and how this margin requirement is passed through to the market participant by its clearing member (rate of return on collateral lodged that the CCP passes to its clearing members and eventually passed through by the clearing member to the market participant).
- The market participant's cost of capital, the degree of netting clearing will achieve on the market participant's positions, and the costs incurred by the market participant of using a clearing member.

Given the complexity of the above mentioned calculation to provide a concrete example would imply the use of speculative figures and would not grant for a reliable conclusion.

Nevertheless, we do have examples of cost of clearing OTC derivative positions. LCH Swaps Clear (the clearing house for interest rate derivatives) does not levy a charge per transaction but instead charges its members an annual fee depending on their level of usage. For members who are considered to be high volume

users the annual charge is £750K. For lower volume members the charge is £250k although an additional monthly maintenance fee is charged.

ICE Clear Europe is the most active clearing house in Europe for CDS business. It does charge a per transaction fee—this depends on whether the trade relates to an index CDS trade or a single name CDS trade. Charges for the latter are more expensive as a more complex risk management procedure must be adopted by the clearing house for these types of trades. For index trades the fee is €4 per million of underlying notional trade. For single names trades (for now only a handful of constituents names of the index) the fee is €10 per million of underlying notional. That is to say a fee on a 10 million trade would be €40. Average trade size tends to be in the 5–10 million range with the bulk of trades being index trades.

In addition to transaction costs market participants using clearing services can incur other types of costs in relation to the initial margin deposits lodged with the clearing house. For example some clearing houses will take a “hair-cut” from the interest rate they pay to the clients for the funds lodged with them eg they might pay 75bp against a prevailing market rate of 100bp (but these figures are theoretical).

J.P. Morgan estimates that central clearing of standardised OTC derivatives would have a limited impact on a firms profitability; they estimate a -0.7% earnings decline, related to infrastructure costs and operating expenses. And they note that these relatively minor costs could be potentially offset by clearing fees for the large derivatives players.⁹

It is important to bear in mind that the fees mentioned above are levied by the clearing house on clearing members. Clearing members pass on those charges to clients as part of their fee structure.

3. It is argued that corporates may have to pay more for their derivatives to help make the system safer. Does this mean that currently corporates with physical positions represent an underpriced risk? Should they hold more capital in the future?

In order to incentivise greater standardisation of contracts and ultimately the greater use of CCP clearing, the Commission has proposed to widen the difference of capital charges between centrally-cleared and bilaterally-cleared contracts in the CRD. This is consistent with the September 2009 G20 communique which agreed that non-centrally cleared contracts should be subject to higher capital requirements than those which are centrally cleared.

Basel’s Policy Development Group (PDG) has tasked the Risk Management and Modelling Group (RMMG) with addressing a number of counterparty credit related issues. The objective is to make the capital charge more sensitive to the factors that drive exposure at default; to require greater capital to be held against OTC exposures; and to continue to provide regulatory capital incentives for the use of central clearing.

The PDG has also tasked the Trading Book Group (TBG) to undertake a fundamental review of trading activities. This work will involve consideration of the appropriate capital requirements for all trading activities.

Although the new capital rules are still in development current proposals would result in financial firms being required to hold additional capital to cover, inter alia, counterparty credit risk, relative to current international standards. This is likely to cover both CCP and non-CCP cleared trades. This should increase the resilience of the financial system. However, the increased cost of capital for financial firms is likely, to some extent, to be passed on to clients in the form of higher costs ie the cost of hedging risk through derivatives is likely to rise for non-financial corporates. This implies that, as a generalisation, the price of counterparty credit risk has historically been under priced (including for those firms with physical positions).

4. How it is possible to effectively standardise contracts and if it is feasible to create terms of contracts (standardise contracts), which would reduce systemic risk?

Advantages to standardising contracts include:

- Reduces operational risk as it makes eg electronic processing easier. This makes it less likely that there will be failures in each party monitoring and discharging their obligations under the contract. Resulting in smoothing operation of the financial system.
- Makes the contract more eligible to be cleared by a CCP. Use of CCPs helps manage counterparty credit risk—effectively CCPs act as a firewall in the system thereby reducing systemic risk.

These advantages can be achieved by introducing market-standard definitions, market practices and templates for the legal documentation that allow users to select from a menu of finite, pre-defined options when structuring the trade. Requiring fixed dates and amounts may not be a requirement to achieve these benefits.

⁹ J.P. Morgan, Global Equity Research, 09 September 2009, Global Investment Banks, (www.morganmarkets.com)

The efficient functioning of the market means that the optimal level of standardisation varies as between different types of derivatives. For example, in credit and interest rate swaps the market is already significantly standardised in the form described above. The regulatory focus is on equity derivatives, which are currently on a lower level of standardisation. Commodities are more difficult to “standardise” due to the very wide range of participants who have very different needs, particularly for those hedging a physical position, but the current level of standardisation can be improved. Each asset class will need to be considered on a case-by-case basis and work is already underway to address this.

While the UK Authorities encourage standardisation, it is recognised that a proportion of the OTC derivative market will always reflect demand for bespoke products from firms who want to achieve a desired risk profile. Non-financial firms, in particular, have a legitimate need to transfer their risks using bespoke products. Typically they transfer these risks to financial firms. Financial firms then choose to manage this risk by either dispersing or retaining it. By overly restricting the range of products available, pockets of residual risk may build up. It is important that bespoke products are appropriately risk managed through the use of robust bilateral collateral arrangements and appropriate capital charges.

5. It is argued that a large CCP in London would be good for the London financial centre. A dominant London based CCP would benefit all European counterparties that use it, but in the event of a CCP failure would the UK be the only one to bail it out, despite it being used Europe wide?

At the moment neither the Commission nor any other pan-European regulatory authority would be able to bear the fiscal responsibility in the event of a failure of a UK CCP.

10 February 2010

TUESDAY 9 FEBRUARY 2010

Present	Hooper, B	Northover, B
	Jordan, L	Trefgarne, L
	Marlesford, L	Trimble, L
	Moser, L	Woolmer of Leeds, L (Chairman)

**Memorandum by the Association for Financial Markets in Europe (AFME),
British Banking Association (BBA) and International Swaps and Derivatives Association (ISDA)**

This evidence is provided in response to the House of Lords' Call for Evidence on the European Commission's communications on ensuring efficient, safe and sound derivatives markets.

The International Swaps and Derivatives Association (ISDA) has over 840 member institutions from 58 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective to the regulation of over the counter (OTC) derivatives in the UK.

The British Banking Association (BBA) is the leading association for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of UK or international banking issues and engaging with 37 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £50 billion annually to the UK economy.

The Association for Financial Markets in Europe (AFME) was formed on 1 November 2009 following the merger of the London Investment Banking Association (LIBA) and the European operation of the Securities Industry and Financial Markets Association (SIFMA). AFME represents a broad array of European and global participants in the wholesale financial markets, and its 190 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with SIFMA in the US, and the Asian Securities Industry and Financial Markets Association through the Global Financial Markets Association (GFMA), and provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets.

1. SUMMARY

1.1 We believe that derivatives bring considerable economic benefits, not only to corporates but also to investors, enabling them to hedge and manage counterparty risk. While we do not consider that derivatives were the root cause of the financial crisis, we do acknowledge that many OTC derivatives give a higher degree of counterparty exposure than some other products. As discussed below, the industry has been working for over 10 years to develop initiatives to manage these risks appropriately. These initiatives were tested at the time of the collapse of Lehman Brothers, and enabled an efficient and orderly unwinding of relevant positions.

1.2 We do not consider that central clearing of OTC derivatives should be mandatory. However, we would support moves to make a greater number of OTC derivatives eligible for clearing. Nevertheless, we would also caution that as the number of trades centrally cleared increases, so does the systemic importance of CCPs. This would support an argument that CCPs should be regulated at a national level, so as to facilitate recourse to government support from their national government if this becomes necessary.

1.3 In the same way that we consider that not all OTC derivatives will be eligible for clearing, we also consider that non-cleared OTC derivatives should not be subject to punitive capital charges.

1.4 We would also urge caution regarding the disclosure of individual counterparty information to a trade repository and how regulators and others have access to that information. We would be particularly concerned where entities or persons other than regulators may have access to the information. This causes concerns regarding duties of confidentiality, data protection, professional secrecy and vulnerability of the information to freedom of information requests. We consider that, rather than being regulated, trade repositories should be subject to harmonised global standards, and should be established in such a way as to address the legitimate legal concerns of all parties using them.

1.5 We caution against inappropriate extension of the Market Abuse Directive to capture more of the OTC derivatives market, and have not seen evidence to indicate that position limits would enable regulators to monitor and detect manipulative behaviour. In addition, we would not support the introduction of mandatory minimum collateral levels.

DERIVATIVES

2. *What economic benefits do derivatives bring?*

2.1 Trading activities and innovation in the financial markets can and do provide essential risk management tools which help to reduce the costs of doing business in the broader economy. The benefits of having deep and liquid trading markets in which financial institutions, corporates, wealth managers, end users and individuals can manage their risks, are clearly felt throughout the world economy. Within these markets we believe that OTC derivatives offer significant value to the customers who use them, to the dealers who provide them, and to the financial system in general by enabling the transfer of risk between counterparties. OTC derivatives exist to serve the risk management and investment needs of end-users. These end-users form the backbone of any advanced economy. They include over 90% of the Fortune 500, 50% of mid-sized companies and thousands of other smaller companies.

2.2 It is therefore important to understand the wider economic detriment that excessive regulation of trading and financial innovation would have on the real economy. In addition, non-financial firms (eg, end-users, corporate firms, specialised commodity firms) benefit from being able to use derivatives for hedging and risk management purposes, but did not contribute to the causes of the financial crisis, and are not considered systemic entities for the purposes of the wider financial system. Excessive regulation of OTC derivatives would restrict the ability of these non-financial firms to hedge and manage risk and would significantly hamper their activity in non-financial sectors.

3. *What risks are associated with derivatives and the derivatives markets?*

3.1 There has been a huge growth in the value of the OTC derivatives markets over the last 10 to 15 years, mostly in interest-rate derivatives, but also in credit default swaps (CDS) and foreign exchange derivatives. Derivatives trades, like other types of trades, expose a firm to the danger that their counterparty may default or fail altogether. However, derivatives trades differ from securities transactions in that they have a longer maturity profile in which such a default could occur and derivatives also enable leveraging. For these reasons, a variety of risk management mechanisms have been introduced to control and mitigate derivative risk. The size and complexity of the OTC derivatives markets means that the failure of one large counterparty would have the potential for significant disruption, if techniques developed by regulators and the industry to mitigate such a risk do not work effectively.

3.2 Further, the fact that counterparty exposure will be covered by collateral (for collateralised transactions), reflecting the creditworthiness of the counterparties, means that a downgrade in a counterparty's credit rating could produce disruptive procyclical effects (for example, if a party's credit rating is downgraded, it may need to post more collateral, possibly resulting in cash flow difficulties).

3.3 In addition to the commercial incentives for firms to manage these risks appropriately, the industry and trade associations have implemented various initiatives over the last 10 years to address concerns regarding the terms of OTC derivatives, including developing statements of best practice and guidelines in relation to OTC derivatives.

3.4 Most recently, in a letter to the New York Fed in June 2009,¹ ISDA and the industry expressed a "firm commitment to strengthen the resilience and robustness of the OTC derivatives markets." As we stated, "we are determined to implement changes to risk management, processing and transparency that will significantly transform the risk profile of these important financial markets, and deliver a risk management and processing infrastructure that includes the additional characteristics and benefits of a traditional clearance model, the OTC derivative markets provide important flexibility in terms of products and execution, and will benefit from the strengthening of infrastructure described above."

3.5 We reiterate our commitment to reducing systemic risk in the OTC derivative markets through the following:

- Implementing data repositories as appropriate for non-cleared transactions in these markets to ensure appropriate transparency and disclosure, and to assist global supervisors with oversight and monitoring activities.

¹ A copy of this letter is enclosed with this submission.

- Availability of central clearing of eligible derivative products transacted between dealing firms in these markets.
- Enabling customer access to clearing through either direct access as a clearing member or via indirect access, including the benefits of initial margin segregation and position portability. However, most end-users will not meet the clearing house criteria for direct access as a clearing member, so will be required to access indirectly through a clearing member.
- Delivering robust collateral and margining processes, including portfolio reconciliations, metrics on position and market value breaks, and improved dispute resolution mechanics.
- Updating industry guidance to be more inclusive of buy-side participants.
- Continuing to drive improvement in industry infrastructure as well as to engage and partner with supervisors, globally, to expand upon the substantial improvements that have developed since 2005.

4. *What role did derivatives play in the recent financial crisis?*

4.1 While we do not believe that derivatives were the root cause of the recent financial crisis, and that the poor credit quality of the mortgage market and underlying assets were in fact a far more significant contributing factor, it does appear that derivatives did play a role. For this reason we are committed to enhancing risk management.

4.2 Although the collapse of Lehman Brothers, as counterparty to a large proportion of OTC derivatives trades, might have been expected to cause disruption to the market, in the event the market operated as anticipated.

4.3 The need to close out the risk created by the Lehman Brothers collapse ensured a level of market liquidity in the days following the collapse. The market in certain products dried up, but the vanilla derivatives markets were very active and mostly liquid.

4.4 The Lehman Brothers collapse caused a notional amount of close to \$400 billion to become payable to the buyers of CDS referenced against the insolvent entity. However, in October 2008, a settlement auction was held on Lehman Brothers CDS, allowing counterparties to net off the amounts they owed against amounts owed to them. This meant that the net amount that became payable was substantially reduced to closer to \$5.2 billion.

4.5 In addition, the default management process of LCH.Clearnet's clearing system for swaps (SwapClear) successfully handled Lehman Brothers Special Financing Inc's interest rate swap default, which had a notional value of \$9 trillion. This was achieved through the risk neutralisation and competitive auctioning of the Lehman OTC interest rate swap portfolio among the SwapClear members. SwapClear members seconded experienced personnel to work alongside LCH.Clearnet, and the default was managed within the margin held for Lehman. This was a useful demonstration of how effective an industry led solution can be.

4.6 It was also useful in this situation that the market was fairly comfortable with the overall robustness of the ISDA documentation in the jurisdictions concerned, which had already been subject to previous tests in earlier insolvencies and amended to reflect the case law developed as a result of those insolvencies (eg *Robinson v Peregrine*; *TXU v Enron*).

4.7 We acknowledge that, together with securitisation, the CDS markets featured prominently in the financial crisis as a result of the collapse of Lehman Brothers (as mentioned above). However, OTC derivatives also have a part to play in the recovery of the financial system, for example, allowing investors to hedge risk in unstable markets.

4.8 We also acknowledge that regulatory reform in certain aspects of the OTC derivatives market is necessary.

CLEARING DIRECTIVE

5. *Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?*

5.1 We consider that an increase in the proportion of OTC derivatives centrally cleared will lead to an increase in the systemic importance of CCPs. For this reason we would welcome consistent regulatory standards at an EU or even global level for CCPs, setting out capital, risk management and operational standards.

5.2 However, where CCPs present systemic risk issues they may require access to government support in the same way as other firms of systemic importance (for example, where failure of several members of the CCP results in the failure of the CCP). If CCPs are supervised only at an EU level neither the Commission nor a pan European supervisor will be able to provide funding as a last resort, and there is also a risk that no single Member State will commit to providing funding either.

5.3 As mentioned in the joint FSA and HM Treasury paper on OTC Derivatives,² it has been recognised that supervisory responsibility for financial institutions which ultimately may need the taxpayer to stand behind them should reside with the home State. We agree that responsibility for supervising CCPs should lie with the regulator in the home State of the CCP.

5.4 An EU level directive would set out a frame-work for national supervision, providing a level playing field for EU based CCPs, and also providing for international standards of equivalence.

6. *What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?*

6.1 Any regulation should take account of the work being undertaken at an international level by the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) to review their current recommendations to address issues specific to OTC derivatives.

6.2 We believe that standards for CCPs should ensure:

- CCPs are managed on a sound basis, according to clear rules on important aspects of their risk management systems, including use of collateral, margining, stress testing, guarantee funds etc;
- Fair, transparent pricing for central clearing services;
- Unbundling of services;
- CCPs can determine what transactions they are able to value and clear;
- Full freedom for market participants to choose how (eg directly), where and if they centrally clear their trades; and
- Segregation facilities are available for client money held by clearing members, should such segregation be requested, to enable a smooth transfer of positions and margin in case a clearing member becomes insolvent.

6.3 Any standards for CCPs should also address interoperability. It may also be necessary to consider amending the Settlement Finality Directive to accommodate considerations related to interoperability, for example contagion risk.

7. *Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?*

7.1 We do not consider that central clearing should be made mandatory either through amendments to MiFID or otherwise. We support the position taken by the FSA in its joint paper with HM Treasury on reforming OTC derivatives markets,³ in which the FSA states that CCPs should not be forced to clear a product if they are unable to manage the risk of doing so. Equally, regulators should have the ability to decide a product is not clearing-eligible if they are not comfortable with the risk management processes available in CCPs. If a CCP is required to clear a product that it is not able to risk manage adequately, there may be the potential for serious difficulties in the event of a default.

7.2 We do not consider that “standardisation” is the only test for rendering a contract eligible for clearing. Other factors such as liquidity and availability of alternative venues should also be taken into account.

7.3 The FSA recognised in the joint paper that there may be circumstances in which the more appropriate risk management approach is to manage a clearing-eligible position alongside a non-clearing eligible position with the same counterparty outside of the clearing house. The FSA also recognised the costs and difficulties that certain market participants could have in accessing CCP clearing, and the impact that mandating central clearing could have on them.

7.4 There are also concerns over mandating the use of clearing by non-financial firms. If non-financial firms were forced to clear products, the requirement to post both initial and variation margin to the clearing house or their clearing member would increase costs and introduce an unpredictable liquidity burden. In order to meet their liquidity needs, it is likely that non-financials would be dependent on financial firms extending them credit which would then transfer the counterparty risk back to the financial sector rather than mitigating it.

7.5 In addition, non-financial firms do not have the same access to liquidity that financial institutions have. As a result, the requirement to provide cash collateral would have the effect of converting the primary risk for non-financial firms from counterparty risk into liquidity risk. Although non-financial firms have considerable

² Reforming OTC Derivatives Markets (December 2009)

³ Reforming OTC Derivatives Markets (December 2009)

experience in managing counterparty risk, managing the unpredictable liquidity risk which arises through collateral requirements is more difficult for them.

7.6 We agree with the FSA that all market participants should have access to the benefits of CCP clearing for clearing-eligible OTC derivatives. The industry has committed to measures which will increase the number of trades cleared for interest rate derivatives and credit default swaps, and to increase the proportion of credit derivatives that are eligible for CCP clearing. Progress in developing these measures is being actively monitored by regulators.

7.7 A thorough cost-benefit analysis should be conducted as part of the process of considering whether and to what extent clearing is appropriate for OTC derivatives.

8. *Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?*²

8.1 We understand the desire in the current climate to increase the regulatory capital requirements against exposures in firms' trading books.

8.2 In principle we support the Basel Committee's current focus on strengthening the trading book capital charge, provided any resulting rise in capital requirements is reasonable and introduced over an appropriate time-frame. Capital charges should be proportionate to the credit risk involved in a trade. Trades that are not centrally cleared or standardised may be subject to appropriate higher capital charges, taking into account the nature of the counterparty to whom the exposure is outstanding.

8.3 However, we note that there are existing commercial incentives to increase the proportion of trades centrally cleared and to move towards standardising transactions without imposing punitive capital charges.

8.4 In addition, higher capital charges on contracts that are ill-suited to central clearing may simply disincentivise market participants from using them (as this would make their use prohibitively expensive). This would have a significant effect on energy markets and on the users of derivatives. For example, in the case of energy derivatives, higher capital charges would damage Europe's energy production and supply capacity, market participants feeling discouraged from making major investments by an inability to hedge the commercial risks they face in an economical or efficient manner—contradicting the development of a single EU competitive energy market.

TRADE REPOSITORY DIRECTIVE

9. *What benefits do the use of trade repositories bring both in terms of transparency and improved risk management?*⁴

9.1 The core functionality of a trade repository is to ensure storage of accurate trade data in order to enable users to have comfort over the accuracy of reports they obtain on the market. This efficient reporting function is the key benefit associated with trade repositories. It is not the core function of a trade repository to provide the sole official contractual record of a transaction. Further, in keeping with the purpose of a trade repository as a store of data for the purposes of facilitating reporting it should be noted that a trade repository would not keep a record of all trade attributes, only those that are necessary for reporting purposes and therefore not sufficient to be classed as an "official contractual record" (or "golden record").

9.2 Trade repositories should provide global transparency on position information (and, through market participants' interactions with them, may additionally reinforce the efficiency of the post-trading process).

9.3 However, dealers in OTC derivatives will often owe duties to their clients and counterparties to keep information relating to their affairs confidential. These duties may be reinforced by privacy or data protection laws, particularly in cases where the client or counterparty is an individual (natural person). Some clients or counterparties may have concerns about the extent to which trade repositories may be able to disclose information about individual transactions, including their individual details, to a broad range of other regulators or governmental entities around the world, who themselves may be able or required to disclose that information to other agencies. Reporting to a trade repository is fundamentally different from transaction reporting to a home State regulator, who would only pass on information in certain well-defined situations.

9.4 Establishment of trade repositories should be market led. Market participants and regulators would be best served by establishing a single, global trade repository for each asset class. Establishment of multiple trade repositories would run the risk of fragmenting the systemic-risk picture, thereby defeating the primary purpose of trade repositories. It would also give rise to duplication (given the global nature of markets), and so reduce efficiency and be more costly.

⁴ A copy of ISDA's November 2009 response to CESR/09-837 on Trade Repositories in the European Union is attached to this letter.

9.5 Currently, the Depository Trust & Clearing Corporation (DTCC)'s Trade Information Warehouse (TIW) provides the only comprehensive database and repository for OTC credit derivatives. TIW provides a central, automated repository to house and service virtually all CDS contracts, and also provides additional services which would not necessarily be provided by other trade repositories (including supporting novation of contracts to CCPs, enabling participants to assign contracts electronically, managing life cycle credit events (eg bankruptcies), and providing settlement services). TIW publishes aggregated OTC derivatives data publicly on a weekly basis on the DTCC website, and has also been providing regulators in the US and Europe with information, with the consent of the relevant market participants where this is necessary. Two other repositories are currently being established. These are MarkitSERV (a new company established by Markit and DTCC) and TriOptima.

9.6 However, we would question whether either regulatory or "societal" interests are served by requiring either regular reporting to regulators or publication of details on bespoke bilateral transactions that cannot be transacted on exchange or cleared through CCPs. Record keeping obligations mean that regulators can access such information on request and their very nature means they cannot be included in any standardised transparency regime.

9.7 We would urge caution regarding the disclosure to the public of information held by a trade repository. Such information would be commercially sensitive and should only be used by regulators for supervisory and market oversight purposes. In addition to the concerns regarding commercial sensitivity, the public disclosure of information held within data repositories may be of little value to the public and could risk providing a misleading picture of either an individual firm's exposures or the wider market. Public disclosure of information could also prejudice a firm's ability to hedge appropriately.

9.8 To the extent that supervisors use trade repositories to monitor market risk exposures, it is important to note the limitations of trade repositories that only relate to OTC derivatives. Specifically, it is important to note that the risk/position view within the trade repository may be incomplete, from both the individual firm and industry perspective, as underlying positions being hedged (which will include, inter alia, securities, loans, listed derivatives and other asset class OTC derivative positions) will not be reflected in the trade repository and therefore will not provide a view of the overall risk position in most cases. More generally, every firm has its own risk management process and there is no substitute for a supervisor's review of regulated firms on a firm-by-firm basis.

9.9 We would recommend that a thorough cost-benefit analysis be undertaken to ensure that a proportionate balance is struck between the cost of providing increasingly granular information, and the benefit brought by providing this information to supervisors. In particular, it would be useful to know whether the increased cost of providing a higher level of detail is met by a corresponding increase in the benefit to supervisors and the markets.

10. *Should the EU regulate the legal framework for the operation of trade repositories?*

10.1 We believe that there should be a harmonised global standard for the operation of trade repositories. We do not believe at this stage that there is a need for regulation (except where necessary to address the confidentiality concerns mentioned above). However, further consideration may be needed on various issues depending on the nature of the repository (for example, public body or private company, insolvency procedures (where relevant) etc).

10.2 We also do not believe that trade repositories should be established on a "regional" basis, or that trades should be divided into "European" and "non-European" trades that should be registered in a European or non-European trade repository. There should be only one trade repository per asset class globally to avoid fragmentation of data. Each relevant regulator should then have the ability to request the relevant data from each trade repository to enable them to perform their responsibilities. The global nature of the trade repositories would mean that it would not be appropriate for them to be regulated at a national or EU level, but rather that they should be subject to global standards.

11. *What provisions and rules should such regulation impose to improve regulation of trade repositories?*

11.1 As we mention above, although trade repositories should operate in accordance with a global standard rather than be subject to national or EU regulation, it may be necessary to address concerns which arise under national law in order to improve confidence in trade repositories.

11.2 Dealers will wish to ensure that there is a clear legal framework which does not expose them to risks of liability to their clients or counterparties as a result of disclosure of client and counterparty details to a trade repository. Similarly, market participants will wish to understand the circumstances in which a trade repository may be able to disclose their individual details to third parties on an identifiable basis. It will be necessary to

establish clear criteria as to how to determine which regulators around the world are able to obtain data from trade repositories (and whether there are any limits on the data they are allowed to request from trade repositories), as well as to establish the extent to which those regulators may be entitled or required to disclose that information to third parties and the extent of their ability to refuse third party request for disclosed data. Similarly, it will be necessary to establish the extent to which, as private bodies (if relevant), trade repositories may be liable to disclose information as a result of litigation between third parties or to law enforcement agencies (or in response to judicial assistance arrangements). Market participants will wish to see that there is a legal framework regulating the trade repositories that provides adequate protection for their information.

11.3 Each trade repository should have a business continuity plan of its own, and should be set up in such a way as to address the legitimate legal concerns of all parties using it (for example, the confidentiality concerns raised above).

12. *Should trade repositories be supervised by ESMA or by national supervisory authorities?*

12.1 As set out in our responses to questions 9 and 10 above, we consider that trade repositories should operate in accordance with a global standard rather than be subject to national or EU regulation. Given the global context of trade repositories it would not be appropriate for ESMA to have supervisory powers over trade repositories. Nor do we consider that it would be appropriate for national supervisory authorities to have supervisory powers over trade repositories, although to the extent that it is necessary to address concerns which arise under national law it may be appropriate for national supervisory authorities to have some involvement in this process.

12.2 This contrasts with our view that CCPs should be nationally regulated. The contrast arises because of the fundamental difference between CCPs and trade repositories, which means that a CCP could present a systemic risk (for example, where the failure of several members of the CCP results in the failure of the CCP) while a trade repository is simply an information storage system, which will not present a systemic risk. It will be necessary to take into account relevant national confidentiality and data protection laws and regulation when establishing a trade repository, but other than that there is no need to have individual national trade repositories, and in fact this would lead to fragmentation of the available information, making it harder rather than easier to achieve transparency of OTC derivatives.

FURTHER ISSUES

13. *The Commission intends to review the Market Abuse Directive and may extend its scope to capture more OTC derivatives and give regulators the power to set position limits. Will this improve the integrity of derivatives markets as intended?*

13.1 We strongly believe that an extension of the MAD to cover OTC and spot markets in commodity derivatives and similar products is not advisable, and further work would need to be undertaken to establish whether there is a significant risk of abuse occurring in these markets.

13.2 With regard to OTC securities derivatives, there is currently no harmonised EU requirement for transaction reporting of all OTC derivatives. Unless regulators across Europe require transaction reporting of OTC securities derivatives, it may be difficult for regulators to gather sufficient market data on OTC securities derivatives to determine whether there has been a breach of relevant market abuse rules.

13.3 The FSA currently requires transaction reporting for OTC securities derivatives where their underlying instruments are admitted to trading on a regulated or prescribed market, to enable the FSA to monitor the markets in these instruments more effectively. We would support an extension at an EU level of the transaction reporting regime to include OTC securities derivatives where their underlying instruments are admitted to trading on a regulated or prescribed market.

13.4 Regarding position limits, we support the view taken by the FSA and HM Treasury in their joint paper on OTC derivatives⁵ where they state that they have not seen evidence to indicate that a blanket approach through specific position limits is the most effective way to monitor, detect and deter manipulative behaviour in derivative markets, whether they are on-exchange or OTC. Nor is there any evidence which demonstrates that prices of commodities, or other financial derivatives, can be effectively controlled through the mandatory operation of regulatory tools such as position limits. The Commission should undertake further analysis to establish whether imposition of position limits would achieve the desired effect, and to ensure that there would not be unintended adverse consequences. We agree with the FSA and HM Treasury statement that a broader position management approach which does not focus on one type of participant would be the most effective approach to ensuring market integrity in derivatives markets.

⁵ Reforming OTC Derivatives Markets (December 2009)

14. *The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?*

14.1 We do not consider that introducing mandatory minimum collateral levels will necessarily increase stability. Bilateral collateralisation arrangements should be subject to appropriate risk management procedures. However, it is not possible to state a level of collateralisation that will be appropriate in every circumstance. With an increasing proportion of OTC derivatives becoming eligible for central clearing, the proportion of bilaterally cleared contracts will decrease. The contracts which remain to be cleared bilaterally are likely to be those which are particularly tailored to the requirements of the counterparties or the nature of the assets. For this reason, while it may be desirable to encourage higher levels of collateralisation, it would be difficult to specify levels which will be appropriate in any given situation.

14.2 We consider that regular portfolio reconciliation would address many of the stability issues and would also reduce collateral disputes.

14.3 In relation to non-financial firms, as mentioned in our response to question 6 above, the requirement for firms to post both initial and variation margin to the clearing house or their clearing member would increase costs and introduce an unpredictable liquidity burden. This could expose the financial counterparty to increased counterparty risk on the non-financial firm, and also have the effect of changing the primary risk for non-financial end users from counterparty risk to liquidity risk, as discussed above.

14.4 In the wake of the market events of 2008, ISDA has proposed a “Best Practices” document (to be published by 30 June 2010), to be sponsored and adhered to across both buy-side and sell-side participants in the market. In this document ISDA will identify the best-in-class standards that are being used in the market today and work towards having firms adopt these practices over time. The document will distinguish between current best practices and best practices ISDA would ideally adopt when the industry is ready. ISDA intends this document to contain best practices focused specifically on the collateral operations aspects covering the following areas:

- Contents, issuance timing and settlement of margin calls;
- Operational procedures for dealing with maintaining data quality;
- Valuation and calculation of margin exposure for both independent margin and variation margin;
- Handling of special life cycle events such as credit events, settlement risk of unwinds, novations etc.;
- Portfolio Reconciliations (already published in December 2009 as a separate document);
- Dispute resolution based on the work to be delivered in May and June 2010 as appropriate.

14.5 In addition, as the Commission noted in its staff working paper on Possible initiatives to enhance the resilience of OTC Derivatives Markets, published on 7 July 2009, “counterparties in commodity derivatives are non-financial firms and as such less accustomed to collateral or exempt from collateral provisioning. Moreover, collateral provisioning is complemented for physical trades that are not marked-to-market by other sorts of assurances, such as parent company guarantees, pledge of assets, prepayments or letters of credit”. We agree with this statement.

14.6 We also support the adoption of a Netting Directive, which would ensure more legal certainty in the market, reduce counterparty risk on a harmonised EU basis, and complement and enhance the effectiveness of bilateral collateral management as a risk mitigant. We believe that any legislative instruments that the European Commission may consider in this context should be developed with the specifics of different derivative asset classes in mind, and the nature of the different participants in these markets.

15. *Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?*

15.1 It is clear that the US legislative programme for derivatives markets is significantly more advanced than that in the EU. This is due to the fact that a new US administration took charge at the start of 2009, while the new European Commission will not be in place until mid February 2010. It was difficult for the previous regimes to implement regulatory change when their term in power was drawing to an end.

15.2 We believe that the extra time that the European Commission has had to consider these issues has allowed them to ensure an inclusive and thorough review of the issues.

15.3 The reform process in the US has been a contentious and highly politicised one. However, it is too early at this stage to say what the result of the reform process in the US will be. Many high level issues have yet to be decided, and could be subject to significant further change both in the Senate and in rule-making by the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC).

15.4 In addition, it is clear that European Commission officials are co-operating closely with their US counterparts, and that this co-operation will continue to act as a “converging” force. We believe that EU views are quite likely to influence the course of US regulation as it advances, and vice versa.

15.5 Equally, while European Commission officials and other key figures in the EU legislative process will seek to converge with US regulation to the maximum extent possible, we believe that they will evaluate the outcome of US regulation, with a view to deciding whether any regulatory steps taking in the US would damage or benefit the EU economy, and will consider how to act accordingly.

16. *Are there further areas for regulation that the communications do not cover?*

16.1 As mentioned previously, we have campaigned for some years for the European Commission to adopt proposals for a Netting Directive, which would increase legal certainty across the EU single market in relation to OTC derivative contracts.

16.2 Alastair Darling is among those who have commented recently that it is the connections between institutions that cause problems, not the individual institutions themselves. A Netting Directive would help to address the connections between institutions, reducing counterparty exposure and enhancing the effectiveness of bilateral collateral management.

For more information on this paper please contact Roger Cogan, Director of European Policy (00 32 2 4018760; rcogan@isda.org) or Ross Barrett, Director of Capital Markets, BBA (0207 216 8841; ross.barrett@bba.org.uk).

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Examination of Witness

Witness: MR ERAJ SHIRVANI, Chairman, and MR RICHARD METCALFE, Head of Global Policy, International Swaps and Derivatives Association (ISDA), examined.

Q65 Chairman: Good morning, Mr Shirvani and Mr Metcalfe. Thank you for sparing us your time to give evidence to us this morning. You should have in front of you a note of declaration of interests. May I add to that, with her apologies, from Baroness Cohen, the Lord Chairman, that she asks me to give a declaration of interest on her behalf. She is a non-executive director of the London Stock Exchange and, through their subsidiary, Borsa Italiana, which has a subsidiary company CC&G, a clearing house for everything traded by Borsa Italiana, and also for EDX Derivatives based in London. Could I start off by asking if there is anything that you would like to say by way of introduction before we go to the questions?

Mr Shirvani: Thank you very much for this opportunity to address the sub-committee. I will just introduce myself and allow Mr Metcalfe to do the same. I have prepared a brief (less than two minute) introductory statement, and then we will be delighted to answer your questions. I am the Chairman of ISDA, and I am also Managing Director and Head of Fixed Income at Credit Suisse.

Mr Metcalfe: Richard Metcalfe, Head of Policy for ISDA. I have been with the Association for about 10 years.

Mr Shirvani: As you know, ISDA represents a range of companies involved in privately negotiated derivatives; that includes diversified dealer firms, such as Credit Suisse; but it also includes a large number of service providers that are important to London as a financial centre, such as law and

accountancy firms. It also includes the so-called “end-users”; the asset managers, the national debt offices and the corporate treasury departments for whom tailored OTC derivatives are essential to manage the risks inherent in their businesses. In fact, the single biggest portion of ISDA’s membership is made up of customers; and a number of end-users sit on our Board. In performing their vital risk-transfer role, derivatives convey important information about risk appetite. In some ways they are like the thermometer that measures the temperature of the financial system. Our concern is that we seem to be blaming the thermometer for the fact that the patient is running a fever. Yes, there are certain risks associated with OTC derivatives; but we know what those risks are; and we are actively addressing them. That is why the OTC derivatives markets continue to function—even after the default of one of its biggest participants in September 2008—at a time when many other markets, including the corporate bond market, simply froze. I refer, of course, to the Lehman Brothers episode. As you may know, only one of Lehman’s 900,000 OTC derivatives trades has been challenged due to an open confirmation. Clearly, there is a role for better management, as well as regulatory supervision of firms. In our view, there are several important components to this: including more effective supervision and, to facilitate more effective supervision, transparency to supervisors, which we as an industry are providing through trade repositories. I can talk about that more later. Supervisors appreciate this, as reflected in recent

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papers from the FSA and the Federal Reserve Bank of New York. There are many other initiatives that the industry is working on, at the same time as we engage in the legislative debate. I will gladly go into the details of those initiatives as relevant; but broadly we see three areas where the industry-supervisory partnership will deliver the right framework, particularly where legal and process standardisation are concerned: counterparty risk management, which includes the careful use of central counterparties; systemic risk oversight, where trade repositories are crucial; and operational robustness, which we believe is largely in place. In summary, I cannot overstate the scale and significance of the infrastructure improvements the industry has achieved over the past 18 months, and continues to work on (with the input of the regulatory community) to better contain risk and to bring transparency that supervisors need to monitor financial industry activity. We are committed to working with the regulatory and supervisory communities to devise constructive solutions, such as an EU Netting Directive, to ensure that we craft the right framework to withstand the knocks of economic volatility. With that said, I would be delighted to respond to your questions.

Q66 Chairman: Thank you very much indeed. Could I start off by asking a very simple question. People outside of your industry simply do not understand derivatives; they are frightened by the term. Tell us in very, very simple terms: what are derivatives?

Mr Shirvani: There are so many different types of derivatives, but the one that is most commonly used is an interest rate swap and a credit default swap. Interest rate swaps are literally if, when you look at a mortgage you can decide to pay a fixed rate or a floating rate, the swap allows you to take a floating rate and swap it into a fixed rate or vice-versa. So two different counterparties, two different organisations or individuals can enter into a swap—one can pay fixed and receive floating, and the other way around. Each one of you, when you take out a mortgage or whatever you do, are actually working in some ways in the derivatives markets; because you may want to pay a fixed rate mortgage or a floating rate mortgage. That swap of payments is really a derivatives transaction. I see you smiling and saying that is oversimplifying it but, honestly, it is very, very simple from that perspective. A credit default swap is again the same thing. In our lives we have exposures to different credits out there, and we choose to protect ourselves in some ways and so we can off lay that risk through a credit default swap. It is really buying credit exposure, or selling credit exposure. You can do that in cash form, in bond form or in synthetic form, meaning derivative form; but really it is about taking some type of exposure. In most cases what happens is—think about if a company owes your

company some money, you have an exposure to that company; to protect yourself against that exposure you can enter into a credit default swap that nullifies or hedges against that risk that you are concerned about. So it is really used as a risk mitigation tool in many cases.

Q67 Chairman: Does regulation need to be appropriately tailored to different types of derivatives? Is a one-size-fits-all approach appropriate in derivatives markets?

Mr Shirvani: We believe that that is not the right approach, and in fact we have to tailor on regulation and we would like to work with regulators and legislators to craft the right type of legislation to make sure that we capture all the different nuances so we can make sure we do not impede capital formation, and that we do not actually increase risks for companies by stopping them being able to hedge their risks.

Q68 Chairman: Can you give the Committee an example where different parts of different kinds of derivatives markets need a different approach to regulation?

Mr Shirvani: For example, there are several different classes of derivatives: interest rate, credit, equity derivatives and currency derivatives, so all of these affect derivatives. In each one of these cases the markets and the participants in those markets are very, very different. We would say you have to be very careful not to go across asset classes with the same type of regulation. Also, depending on the complexity of the derivative, we want to make sure that the right type of regulations attach to it. It is very standardised, and liquid derivatives we think can potentially be exchange-traded, but definitely cleared; but there are certain bilateral contracts that are very, very specific that we think do not lend themselves to clearing, mandated clearing or exchange trading. For example, a company might be expecting dollars on 13th of the month from someone it is expecting to receive some dollars from. If they were going to hedge that payment and they could only hedge it to specific dates in the exchange traded or the cleared contracts that would leave them with 15 days of exposure; so we would like them to be able to hedge that exposure to the exact date where they are expecting a payment or expecting to make a payment.

Q69 Lord Marlesford: You have just been giving some very interesting examples of derivatives which we will study carefully. I think it would be quite helpful to have a definition so can I just try on you the definition given by Lucy Prebble in her Enron glossary, and she says: “A financial instrument that is derived from an asset (known as the underlying

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asset). Rather than buy and sell the asset itself, traders can buy or sell derivatives of the asset allowing them to speculate on whether they think the price of the underlying asset is going up or down". Do you think that is a reasonable definition?

Mr Shirvani: Yes.

Lord Marlesford: Thank you very much. The question I wanted to ask is: we have heard some comments that some of the proposals set out in the Commission Communications will have an adverse effect on non-financial corporates that use derivatives to hedge risk. Do you agree that these proposals may adversely affect these companies? Do you agree with the suggestion that the proposals impose extra costs on non-financial users of derivatives? Should corporates be granted an exemption from clearing or collateral requirements? In the context of that, what we are trying really to get at is whether what the Commission is proposing is necessary or is going to work. I was very struck in your evidence where you gave the example you have already referred to of Lehman Brothers and particularly, just quoting two of your figures, where you said that the collapse caused a notional amount of close to 400 billion to become payable to the buyers of CDSs against the insolvent entity, but you got a settlement which substantially reduces to close to 5.2 billion. So I suppose what I am really seeking to know is whether if what the Commission is proposing would: one, have changed Lehman Brothers' behaviour initially, and whether they would have had the same situation; and, two, if they had the same situation, would it have made the solution to it, which you have described, any better?

Q70 Chairman: Could you deal with that in two parts?

Mr Shirvani: Of course. On the first question I think there are three points to make: one is, requiring end users or corporates to post collateral, to post margin, will increase their costs, which is something that they will then pass on to customers, and it will impede their ability to best tailor their risk management. Even National Grid—and Lord Myners referred to National Grid in his testimony last week, I believe—has very specifically said, "We are strongly against any proposal which will limit the ability of the company to tailor derivative transactions to match underlying assets and liabilities". One of the things that is very interesting here is, at a time when all governments are trying to get banks to, in a sense, lend credit, provide credit to companies, to end users, this specific proposal would actually stop that process from going forward because it would actually create a need for corporates to post collateral and tie up capital that they could use providing jobs, building factories or whatever. So we do not think that is a very good idea from that perspective.

Second, it would impede them to tailor-make specific hedging solutions for the risks. Those two things are very, very important as potentially unintended consequences of any kind of proposed legislation you are referring to.

Mr Metcalfe: On whether EU legislation would have improved the situation, with the possible exception of having a Netting Directive which applied the same rules across all EU Member States, no, I do not think it would have improved the situation. The point, from our point of view, is that existing techniques to manage counterparty risk vis-à-vis Lehman Brothers did work very well indeed, as they were intended to do. CCPs provide some additional benefit, not least in providing market confidence, but that is a difference of degree rather than a difference of kind.

Q71 Lord Trefgarne: In your evidence you suggest that there should be moves to more contracts eligible for CCP clearing. What benefits do you think this would bring; and what costs might it impose on users; and will it reduce the risk to the financial system caused by OTC derivatives?

Mr Shirvani: These are different questions. On the one hand, I would say that the bilateral framework that we have right now, especially in the intra-dealer market—so two banks trading against each other—95% of that business is highly, highly collateralised; so that there are no real risks in those types of trades. Clearly bringing a central counterparty in place creates more transparency for supervisors. One of the problems we had during the crisis was that it was very difficult to get standard information from each of the banks that you could really look at from an apples-to-apples perspective. All the different national regulators were asking for slightly different types of information, so they could not compare with each other. One of the things we have really tried very hard to do in the aftermath is, one, through the central repositories to make sure that the same type of information is available to every regulator and to every supervisor, so that they can be able to speak to each other in a common language. A central counterparty what it does do is it does allow supervisors to go to one place and look at exactly what the risks are systemically. At the same time though there are obviously costs associated with that. For one thing, having an entity that is so systemically significant could create the next problem potentially; so we have to make sure that those entities are well capitalised, that guarantee funds are sufficient to cover any potential problems. Some central counterparties have actually thought about applying to their central banks for direct liquidity lines; that in and of itself perhaps would give you some insight into the fact that they believed that they could become systemically very significant at a time of economic turmoil again. There are positives—transparency,

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getting information in one place, golden source of data; but there are some potential negatives—creating the next financially or systemically significant entity. We have to balance those two together. I think the transparency question probably wins the day at this point. We just have to make sure we have effective supervision and that, I think, is the next challenge. Once we get through the legislation, once we get through the political process, we have to make sure we implement the supervisory; and that then goes to global harmonisation and making sure that the different central counterparties can operate with each other or under the same basic guidelines on a global basis so there is no arbitrage between different localities and different regulatory regimes. It becomes very, very complicated from that perspective but I think that good debate is occurring on this—very thoughtful debate.

Q72 Lord Jordan: You have said that central clearing can be a good thing. If that is the case why should it not be mandatory? If it is good for one why is not good for all? Can you set out the reasons for why it should not? Should incentives be created through the EU legislation to make it more attractive to use central clearing?

Mr Metcalfe: The point we believe about clearing is that it is not applicable to all financial instruments—not safely applicable to all financial instruments.

Q73 Lord Jordan: Why not?

Mr Metcalfe: The real reason for that relates to the ability of the clearing house to manage the risks associated with positions upon the default of a clearing member. That will necessarily impose a requirement to focus purely on the liquid financial instruments. That is a very important distinction, as compared with the standardisation term that is sometimes used. You can have standardised products which are not liquid. For a clearing house safely to clear, without adding to systemic risk it has to focus on a certain range of necessarily heavily traded instruments. In focussing on those instruments it will be addressing the counterparty risk that goes with exposures taken on through those trading activities. I might add, that would be a mix of hedging and speculative activity. If you have a situation where it is possible to define which products are eligible for clearing, suitable for clearing, then provided you get the incentives right it should not be necessary to make it mandatory. Making the clearing of all OTC derivatives mandatory would be very dangerous because you would include instruments that were not appropriate for clearing. Making the clearing of all eligible instruments—in other words, all instruments which are in theory suitable for clearing—mandatory should not be necessary; and at the margins there may be some grounds for excluding some contracts

for clearing—a small proportion, but some to do with the existing bilateral relationships that would still exist with corporate and other customers outside of the clearing world, to do with the balance of risk within those relationships.

Mr Shirvani: You might think in a situation where you and I have two trades on in two different asset classes, if we are mandated to clear everything in some cases it might actually create more risk forming because it might break up my counterparty exposure between what I have on the cash side versus what I have on the CDS side. On the CDS side, for example, on the derivative side I might have my counterparty be the central counterparty, but on the cash side I might have my counterparty be another entity that I cannot hedge. I may want to have the two transactions linked so that I have offsetting transactions to that one counterparty. We think if you have put the right infrastructure in place in the legislation and give some level of ability for the actual supervisors to make those calls on an ongoing basis as they see appropriate that is probably the right way forward.

Q74 Lord Trimble: You have mentioned already that increased use of central clearing might increase the systemic risk or the systemic importance of central counterparties. Could you explain why central counterparties will become systemically important, and what risks they pose to the market?

Mr Shirvani: I want to stress that central clearing is a vast improvement; and we should all be working on making sure that that works properly and that we clear as much as prudent through a central clearer. That being said, any time you focus that many financial trades through one entity, at some point it is just going to be so large and it is going to be handling such a high percentage of trades that it just, by virtue of its size, becomes systemically significant. In case there is a problem that occurs in the market, or any kind of dislocation, if that guarantee fund (for whatever reason) is not sized correctly it can then pose a very, very large issue to the market. You might say, “Why don’t we size that guarantee fund to make sure it manages every potential risk?” The answer is, in our personal lives if we did that then we would not take out any credit and we would not spend any money going forward; we would just make it and spend it at the same time; and most of us do not do that; we make some projections as to what kind of incomings we are going to have. Guarantee funds work the same way; they cover the majority of risks but not the entirety of risks. If they were to cover the entirety of risks then it would just be commercially unreasonable to deal with those trades, unattractive to do those trades.

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Q75 Lord Trimble: We are using Lehmans quite a bit in this obviously but, like others, I was struck with the way in which Lehmans would seem to have a huge amount of trade there and that it all netted out very easily and there was no significant loss. Why would the same not occur with regard to central counterparties? If there was a problem there would they not be able to net everything out and probably find, like Lehmans, that there was very little problem at the end of the day?

Mr Shirvani: To a large extent we expect the same thing would happen, but that during that process there may or may not be a shortfall and, given the size of it, there could be some concerns as to whether the guarantee fund covers everything; which is one of the reasons we are saying central clearing is a good thing and should be followed. We just make the point that it could become a systemically significant size at a time when a lot of legislatures around the world are talking about limiting the size of any institution that gets to a certain point. It just follows to make that point, that the central clearer could hit those kinds of systemically significant sizes as well.

Q76 Baroness Hooper: Given all that, do you think that EU level regulation will help reduce the risk of enlarged CCPs as far as financial stability is concerned? On what areas should standards for CCPs focus?

Mr Shirvani: We are very focussed on making sure that there is global harmonisation of standards so that there is no, as I said, ability for arbitrage to occur. Within the CCPs one of the things we are concerned about is that—as this market is trying to react very quickly to all the different national level regulators, and just as industry as a whole is trying to get its infrastructure in place—we have CCPs that as they grow are not necessarily growing under one standard. There is an issue of fungibility and interoperability between CCPs; and that means being able to move your trades from one central clearer to another; and to do that you want to some level of standardisation, some harmonisation of regulations, so that we have some global framework for all this. That I think has begun but is probably not working as well as we would like to see it happen so far, in the sense that we think the global supervisors to a large extent are communicating, but there seems to be very much still a nationalistic tendency in many cases to get very, very inwardly focussed. We feel very strongly that there has got to be better global coordination.

Q77 Baroness Hooper: Do you see the EU level regulation as a first step?

Mr Shirvani: Absolutely.

Q78 Baroness Hooper: Or do you think we should skip it entirely and just go for global?

Mr Shirvani: No, I am sorry, to be clear, I think it is a very good thing. It is a good place to start but I think we need to, at the same time, be debating on a global basis too; so that the two happen concurrently; so that we do not come to one conclusion in the EU that is not globally consistent around the world. It has to be a concurrent move. It is very difficult and there is not a good answer, frankly.

Q79 Baroness Northover: Linked questions on the supervision of CCPs as opposed to their regulation. You say that CCPs should be supervised at national level, as ultimately the responsibility for bailing out a CCP if necessary would lie with a national Member State government. Could this prove to be to the disadvantage of a Member State where a CCP is based, because they are going to be used globally? Therefore, following on from that risk, should supervision be maintained at EU level rather than national level?

Mr Metcalfe: I suppose there is a danger of going in an endless circle on this, in the sense that you could in theory gain greater backing for any bailout of a CCP by broadening the scope of the funds available to do that. In practical terms, that would not seem to be a realistic option, at least in the short to medium term. From that point of view, the logic of national supervision seems hard to avoid. I think it does actually link back into the previous question; because if you look at what standards actually mean for CCPs, they are about good risk management, and the principles there are not that difficult to lay out. We have had very good principles for a number of years and, just as bilateral netting worked extremely well in the case of Lehman Brothers, so did multilateral netting. You will be hearing from LCH later, I am sure, about that. Provided you adhere to those good and, in some ways, commonsense standards, there is no reason why national supervision should not work perfectly well, just as it does for banking institutions.

Q80 Baroness Northover: You would not see the UK, for example, deciding that it was too risky to have a huge CCP based here because of the risks, even if that is built in?

Mr Metcalfe: No, because a CCP will actually reduce exposures, the size of the exposures, for the instruments for which it is offering clearing. Provided you adhere to that standard as regards what is eligible, you do not clear contracts which are difficult to manage in the situation where a clearing member is insolvent, and therefore financial markets are likely to be difficult. As long as you do not stray into that territory, the risks should be perfectly manageable, and the exposures will be under control. It does, of course, lead you onto a question of good supervision; but I think what we are focussed on here is the regulation and legislation primarily. There will

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always be that question of putting any rules into practice and enforcing them sensibly, of course.

Q81 Chairman: If you were a Spanish politician, a Greek politician or a Portuguese politician today and you saw a lot of speculation going on against their government bonds and so on, and threats to the euro, do you think you would be happy to see supervision of derivatives and all this all being done by the UK in London; or do you think you would be tempted to say that this should all be done at EU level?

Mr Shirvani: It is a difficult one, is it not; you are absolutely right. That is one of the problems that we have seen in difficult circumstances in market dislocations. The national tendencies will win over—perhaps better judgement or coordinated effort. That being said, it is a very difficult situation. The answer from a previous question: you can argue both sides of that. If you are supervising the central clearer and it is in your domicile, but the counterparty that fails is a foreign bank, who should step in, and who should ultimately work to resolve the issue? That question keeps coming up and, as you mentioned, it is one of those things where you may want to be able to have that power at the EU level; and so we believe there is a place for EU-wide regulation here.

Q82 Chairman: We are talking about supervision, of course, and not regulation.

Mr Shirvani: I am sorry, supervision.

Q83 Chairman: Let me put it another way: After the Iceland experience, no disrespect to them, if you have a big CCP in a small European Member State but a very, very large CCP, would Member State supervision really be sensible; or are you assuming that in reality any very large clearing house is going to be in London, Paris or somewhere?

Mr Shirvani: Our expectation is that CCPs will be in large financial centres, yes; domiciled in large financial centres. There is no doubt about that. In some cases you have central clearing houses that will have links globally. There is one called ICE that has both a US clearing house and a European clearing house, for example.

Q84 Chairman: That leads me to the question I was going to ask and that is about the number of clearing houses that currently exist throughout the world. Do you envisage that the number of clearing houses will be determined by the market, or do you think that regulation will step in in some way? Is it important there are clearing houses operating in the EU, as well as in the US and elsewhere? What policy issues does that raise for the EU and the UK? How many and where?

Mr Shirvani: That is a very complicated question. Right now we have had very strong indications from some of our supervisors that they would like to see multiple CCPs in each region—at least at the outset—to foster some level of competition. While we have not been mandated to do that, there have been strong suggestions in the industry that we go down that path. As you can see, we have done that to a large extent both in Europe and the US with EUREX, LCH, ICE and a whole host of others, beginning to look at that space; in the US with ICE and the CME. That has been very much encouraged by our supervisors at this point. We do believe though that clearing does lend itself to being public utility-like. Of course, to a large extent, the more you can put in one place the more efficient the margining is; but, going back to your question, the larger it gets it may pose a systemic issue. So there is this balancing act between how many and how bifurcated the market becomes, versus how large you make one and therefore get some of the netting benefits from the margining that are associated with larger diversification. So that balance is a very difficult one to achieve. Right now we are definitely, as an industry, working very hard to have multiple CCPs in every region. What I think will happen over the next three to five years is that that will, in a sense, rationalise itself into specific players that will become the larger providers. I think there will be industry consolidation in that space within three to five years; but right now we are encouraging multiple CCPs.

Q85 Baroness Hooper: A slight change of tack. Although you have argued for a tailor-made approach, to the layman standardisation has a certain appeal; and clearly the European Commission is advocating this insofar as it is planning to introduce incentives and so on. What benefits do you consider this will bring, and what costs may it impose on users? Will standardisation reduce the risk to the financial system presented by OTC derivatives, or will it hamper initiative and innovation?

Mr Shirvani: Let us say you are a company that is trying to build a factory in Japan and has something they need to pay in Japanese yen but you cannot raise Japanese yen in that market, so you may issue a bond in euros to a specific date when that payment is due, when the factory is completed. Let us say the date that factory is completed is December 15; well that is not a standardised date in the derivatives market. A standardised date would be December 20. Those five days five years from now, where your balance of payments do not connect, will expose you to a risk between the value of the euro and the value of the yen. What you would like to do is match your assets and liabilities as best you can. I am giving you a very simple example, and also just five days. You might

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say, “Well, what’s the big deal with five days”, but as you know, with large sums, even small market moves can matter. What you want to be able to do is match your assets and liabilities as best as possible. On the one hand we may get everyone very comfortable, that we are using standardised contracts but hiding the fact that actually we are creating a huge asset/liability mismatch that could expose that company to much bigger risks in the longer run. Does that make some sense? That is the issue. What we want to be able to maintain is a market whereby a specific instrument can be used to hedge a specific exposure that a company is trying to mitigate—in this case a payment five years hence in yen that it needs to make.

Q86 Baroness Hooper: Does that mean you would not wish for any sort of standardised contracts; or how do you differentiate them?

Mr Shirvani: No, and what is very, very key is that we are actually very big proponents of standardisation but we believe that there are certain segments of the market that can be easily standardised, and in fact we have done a lot of that. As I said, as an industry there is a perception that the industry is against, for example, exchange trading of some of these contracts, whereas actually some of the indices, some of the indexes, are so liquid that they do lend themselves to even exchange trading. We think there are some things that can be exchange traded; there are some things that should be cleared; but then there are still some bespoke trades—and I just gave you that example—where we should have that ability to do those trades on a bilateral basis that are not cleared and are not standardised; but, listen, those will be caught in the central trade repositories so there will be a golden source of that data that will be available to every regulator and every supervisor—I am going forward—and we are building those trade repositories in every region. What you have is a clearing house for all trades that can be cleared; for whatever cannot be cleared, for what does not lend itself to be cleared, you have one database that has the golden source of that data, that trade, very, very clearly laid out, so we will never be in a position where the supervisors wake up one morning and they just cannot get the information; because they will either go to the clearing house to get that information or, whatever is not on the clearing house, the board of trade repository. For every asset class either one of those two institutions will be able to give them very clear transparency as to what the totality of the market looks like.

Mr Metcalfe: There is a list of standardisation measures which we could provide to this Committee afterwards which are to do with legal and post-trade process type of standardisation which are extremely important. I think we have common ground with the Commission—I dare say that we do—in saying that

those are important measures. Where we do draw the line is on economic standardisation of the terms of the contracts. If you force standardisation on those grounds you run into some very significant consequences in terms of the accounting treatment, which will show up as extremely volatile profit and loss for regular companies, which may not be a good thing.

Q87 Lord Trimble: You have been making an argument that you should be able to design particular derivatives for particular situations and not be forced into situations which are creating risk. The Commission I think is suggesting that where we have got derivatives that are not cleared that they should then be required to post some capital against that. I notice in the summary of your evidence that there is reference to saying that “we consider that non-cleared derivatives should not be subject to punitive capital charges”. How do we distinguish between a reasonable requirement in terms of posting some margin and when it becomes punitive? What is happening on that front?

Mr Metcalfe: This is where the work of the Basle Committee at international level becomes vital, because I think in principle at least that still is has as an objective making capital charges proportionate and related to the risk that is actually being run. There is a whole other chapter one could open on that debate, but that is the general principle.

Q88 Lord Moser: Back to standardisation, the counterargument to increasing standardisation of derivatives that has been put to us is that it may actually have the danger of encouraging bilateral deals bypassing the CCP organisation, so to speak. Do you have a view on that? Is that a serious counterargument?

Mr Shirvani: I find it difficult to believe that if there is a central clearing mechanism available for standardised contracts that a firm such as mine would elect not to use it. I am not sure—I think that is a high probability event to occur.

Mr Metcalfe: No, maybe this question should properly go to LCH, but I believe there is \$100 trillion worth of interest rate swaps cleared through that mechanism. That reflects the existing incentives to clear centrally, which are very significant for firms. There is the commercial good sense of reducing your exposures, but you also get a benefit in terms of a reduced capital charge. The incentives to clear are very strong. You have already seen five trillion of credit derivatives cleared from a standing start at the beginning of 2009. I think the willingness to clear is there. The one nuance here may be that there are products in the market now which are currently not liquid enough to clear and therefore would not be eligible, would not be accepted by any clearing house,

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but which may over time become more liquid, and that is precisely what you have seen with credit derivatives.

Q89 Lord Moser: They avoid the clearing?

Mr Metcalfe: It is not so much that they avoid it; it is that they would not be suitable for clearing at one particular stage in their life. This is precisely what has happened with credit derivatives. Ten years ago there would not have been enough of them in the market to make it safe to clear them centrally. Now it is safe to do so, so you have seen moves to introduce clearing for that. Provided there are not other damaging measures to the OTC derivatives markets, you are likely to see a similar pattern in other products; that is the pattern that you saw with interest rate swaps which got you to that 100 trillion figure today, assuming I have my figures correct.

Mr Shirvani: Remember, if there is central clearing available as an option it is always in our interests to centrally clear because of the capital relief we get from that.

Q90 Lord Moser: Is it in the interest of both parties?

Mr Shirvani: Yes.

Q91 Lord Moser: I do not understand that. I do not understand why both parties benefit?

Mr Metcalfe: It is not so much that both parties benefit; the whole market benefits because what you are achieving is multilateral netting. I can offset positions that I might have with you but with somebody else as well. The multilateral net down—on which we can send you a note afterwards perhaps to walk through the mechanics—that benefit is even greater than you achieve in bilateral netting.

Q92 Lord Moser: There is a general worry I have about all of this. The paper that we were sent starts by saying, “We believe that derivatives bring considerable economic benefits”, and that is your belief. I should not question it really, but we spend all our time on this subject, discussing this enormous machinery to regulate, first of all, the partners and then we have the people who are making the deals; and then we put the CCPs in the middle, who are the sort of middlemen to make sure that everybody behaves well, et cetera; and then they have to be regulated because they may not behave well et cetera, et cetera. All of this against a background which we do not bother to discuss that is all such wonderful news for the world, for the economy, that we must go in that direction. As you talk about this, I wondered whether you could say a bit more in your own words. I know derivatives are basically a good thing, but is there any way of quantifying what the world gets out of them against this machinery of making sure that everybody behaves?

Mr Shirvani: Let me attempt that and then I will ask my colleague as well because this is absolutely key, and it is really a question you have to answer for yourself. The question it really comes down to is, the last 10, 15, 20 years of economic prosperity that we have enjoyed globally, that has come from an ability to create more credit, the active credit provision; the growth in the economy has been facilitated by derivatives. If you truly believe that the events of the last year or two have taken us back from a standard of living from a prosperity back 20 years to a smaller, less wealthy world than we had 20 years ago then derivatives have not served their purpose. If you believe that, even with what has happened in the last two years, we are at a better place, people are living in nicer houses, there is more credit provision et cetera, then you have to believe that the innovative products that have created, that have facilitated credit provision and global trade have had some benefits. That is a question I cannot answer for you; it is really a question each one of us has to answer for themselves.

Q93 Lord Moser: You cannot quantify that kind of thing?

Mr Shirvani: For myself, when we look at GDP we look at the standard of living of every citizen in this country; we look at what kind of houses they live in; those are all the benefits we have. The City; what has happened to the tax base in this country et cetera; I would put to you that it has had a tremendously positive impact.

Q94 Lord Moser: I am sure you are right. I am sure nobody else is worried, but as a statistician I always like to quantify things, and there is no way of quantifying the benefits from all this stuff?

Mr Metcalfe: Over 90% of the world’s 500 largest companies use derivatives. That is a proxy measure, but I think it is an interesting one.

Chairman: The kind of explanation you gave, Mr Shirvani, is the kind of explanation that a lot of people were saying about other financial products only two or three years ago and look what happened. So general statements associating a particular activity with global growth, I have to say, will not convince a statistician like Lord Moser. Nevertheless, I have great sympathy with the industry.

Q95 Lord Trimble: You are suggesting that there should be a harmonised framework of minimum standards for trade repositories. Should this be applied to repositories through EU regulation? What actually are the minimum standards you think should be there?

Mr Metcalfe: In a sense, this is very much the same answer as with CCPs. Global standards are appropriate. It is entirely appropriate to translate

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those into the European context with European legislation. We could go into the details on the technical standards but we are broadly comfortable that the world is coming out in the right place with regard to those. There are important issues lurking in there to do with data confidentiality, not just from the point of view of banks' own data but data regarding their customers, which may require very careful attention. We would support the resolution of those issues at the earliest possible opportunity, and it may require European-level action.

Mr Shirvani: The most important part of this is that we should trade, no matter where the repository is domiciled. I believe we should make sure that there is a most favoured nation philosophy in terms of provision of information to every regulatory body that wants it, with some level of discretion in terms of the type of private information that can be disseminated. I think you can get across risk information without getting into a lot of the detail that is not necessary.

Q96 Lord Jordan: My question goes to the comment about confidentiality. To whom should the data collected be available; and, separately, how should supervisors use this information?

Mr Shirvani: As I mentioned, we believe we should make sure that that data is available to supervisors globally on a consistent level but perhaps with some level of confidentiality. In terms of specific names or specific information we think we can provide reports that convey the basic picture systemically and give aggregate risk data without getting into privacy or confidentiality issues. It is a very difficult balance to strike and that is one of the reasons we want to work on this immediately and urgently. As I said in my earlier statements, one of the biggest issues we had was that global regulatory bodies, supervisory bodies, had different levels and types of information so they could not communicate effectively together, so we want the same data to be available to the different regulators, that is very important, while respecting the confidentiality issues.

Q97 Chairman: I would like to ask one last question which relates back to Lord Marlesford's question on Lehman Brothers. One of the problems in the Lehman situation was that margin and collateral payments were not separated from Lehman's other assets. The issue arises of the segregation of margins paid to central counterparties and the segregation of collateral paid to counterparties. What is your view about that? Was that a problem, and what should be done about it?

Mr Metcalfe: We might want to think that one through and come back to you in some detail. In essence, for OTC derivatives the short answer would be no, but would it be acceptable for us to come back to you? We could come back with some other supplementary materials like a written definition of derivatives at the same time.

Mr Shirvani: At the same time I would say that the more capital a dealer has to set aside to purchase an asset, the less assets it can purchase, so we have to balance all these issues to make sure that credit provision continues, especially at a time when we are going to encourage credit provision.

Q98 Chairman: You have been generous with your time and I apologise that we have gone over it. Is there anything you would like to conclude with?

Mr Metcalfe: One closing comment might be that we have not seen any market failure in relation to CCPs in the time since 2007, and I think that is worth bearing in mind when we are considering the difficulties, or otherwise, of supervising them and regulating them.

Mr Shirvani: I would end with global regulatory co-ordination being very key; avoiding adding regulation that may impede capital formation, because at the end of the day that is what is going to help us move forward; issuing a government mandate for every perceived problem is probably not the optimal solution; and we need to make sure we take a measured approach, and please be assured that the industry is very willing and able to help devise a constructive solution. Thank you for the use of your time.

Chairman: Thank you.

Supplementary memorandum by the International Swaps and Derivatives Association (ISDA)

1. THE DEFINITION OF DERIVATIVES

The key purpose of a derivative is the management and especially the mitigation of risk.

When a derivative contract is entered, one party to the deal typically wants to free itself of a specific risk, linked to its commercial activities, such as currency or interest rate risk, over a given time period. It is "hedging"; and the more exact that hedge, the better for the hedging party.

The other party to the deal assumes the risk, though it may then "lay it off" elsewhere, in a process akin to reinsurance. Thus risk passes to those most willing to take it on (including investors, who are used to taking similar risks through other financial instruments).

The value of a derivative contract is determined by the change in value of an “underlying” asset. This characteristic is what allows a precisely targeted over-the-counter (OTC) derivative to cancel out the economic effect of existing exposures. The practical applications are limitless.

2. LEGAL/PROCESS STANDARDISATION OVERVIEW

- Legal documentation—“Master Agreement” framework first established for netting out counterparty exposures in 1985 and steadily extended since then to accommodate new products and jurisdictions. Collateralisation documents added in early 1990s, allowing the securing of residual counterparty exposure.
- Standard procedures for transferring contracts to third parties (subject to the agreement of all relevant parties; known as “novations”).
- A common computer language (called “FpML”) to support the automation of post-trade process, initiated 10 years ago and now widely used.
- Automation of trade detail (“confirmation”) matching at nearly 100%. (Only 1/900,000 trades in Lehman Brothers portfolio was disputed; also, backlogs effectively eliminated.
- Portfolio reconciliation—centralised services for ensuring consistency between pairs of firms as to the data about mutual derivative transactions on their books.
- Dispute resolution—procedures for decisively resolving disagreements between parties as to the value of derivatives (particularly when the correct amount of collateral is to be calculated) ; currently being updated.
- Trade repositories—central databases for transactions in derivatives, supporting supervisory oversight of net risk positions.
- Trade “compression”—reducing counterparty exposures and operational burden by removing economically redundant transactions from firms’ books; (NB compression is applicable to a wider range of products than clearing and has reduced notional amounts in the credit and interest-rate market by \$10s of trillions).
- Standardised settlement procedures, particularly for credit derivatives, where a “Determinations Committee” agrees on whether “trigger” events have in fact occurred, leading to a market-wide process to determine the settlement value (praised by the “Senior Supervisors Group”).
- Central clearing (where feasible)—aggressive targets were met last Autumn (for “G15” banks: 70% of eligible interest rate swaps; 80% of eligible credit derivatives).
- Some forms of economic standardisation, where relevant (eg, standard “coupons” apply to many credit derivatives, making their prices more easily comparable).

3. MULTILATERAL NETTING

Netting is the process of calculating how much “counterparty” credit exposures (ie, exposures between parties to contracts) cancel each other out. Thus, in the case of bilateral netting, if I owe a party 10 on one contract, while they owe me 8 on another, the net amount payable is 2. In multilateral netting, to work out what is payable, I consider what I owe to and am owed by more than one party at a time.

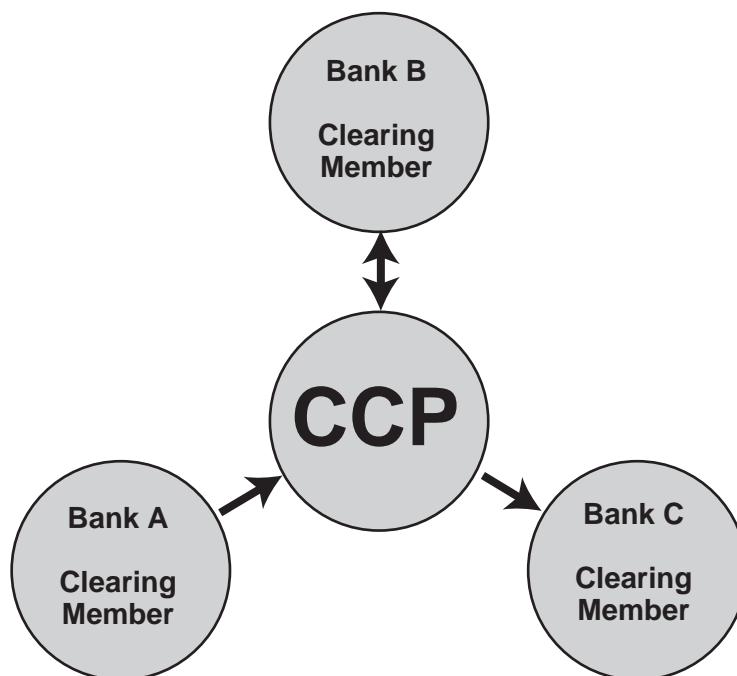
(The “exposures” that are netted arise as a result of derivative contracts acquiring value, ie, upon any changes in value of the “underlying” asset to which the derivative refers. On any contracts which have positive value for me, I rely on the ability of my counterparty to perform at the point of settlement. Often, parties to contracts will cover the risk of default by the counterparty on a positive net exposure, by requiring “collateral” [ie, cash or government bonds such as Gilts].)

Netting routinely applies “bilaterally” between pairs of parties to OTC derivatives (under the terms of a “Master Agreement” between them). Multilateral netting extends the calculation to more than one relationship at once, usually intermediated by a financially strong central counterparty (CCP) that “steps in” between the original parties to a contract. Consider the following illustrative example. Assume that:

- “A” and “B” enter a contract, then the CCP steps in, such that “A” has a contract with the CCP, while the CCP has an equal but opposite contract with “B”; (parties such as “A” and “B” that deal directly with a CCP are known as “clearing members”).
- The value of these contracts today is such that A “owes” the CCP, ie, the CCP is relying on A to perform for it; simultaneously, B is relying on the CCP to perform (for exactly the same amount).

- From a separate contract, initially between B and C but also intermediated by the CCP, B “owes” an amount to the CCP (ie, the CCP is in this case relying on B to perform); the CCP in turn “owes” an identical amount to C.
- Assume also, for the sake of the illustration, that the amounts owed as a result of the “B-CCP-C” contracts are the same as those owed from the “A-CCP-B” contract.

Schematically, this situation can be represented as in the diagram below (with amounts payable upon settlement in the direction *arrow-head*). Note that in the case of Bank “B”, it “owes” money to the CCP but also is “owed” money by the CCP, as a result of the dealings initially carried out with A and C.



In this scenario, B has two offsetting counterparty exposure positions (both of them with the CCP); while A owes money to the CCP and C is owed money by the CCP. In the B-CCP relationship, there is zero current counterparty credit exposure. Vis-a-vis A and C, there is net exposure for the CCP to A and for C to the CCP.

The CCP will require amounts of collateral from A, B and C accordingly, reflecting these net positions. B will still post some amount of collateral (for the general strength of the CCP). So will C. A (which is the party on whom performance effectively depends) will post much more than either B or C.

(In the event of B’s default, C’s exposure would be to the CCP—not to B—while the CCP would still have a surviving counterparty in A. In practice, the CCP would then look to other clearing-member parties to take on the contracts which B had on its books, to ensure its own book reverted to the same mix of contracts as before the default of B. It is at this point that the collateral taken by the CCP becomes important, cushioning it against any losses on those positions while it seeks to replicate them.)

4. COLLATERAL RETRIEVAL

As outlined above, one party (“A”) posts collateral to another (“B”) when a contract (or, on a net basis, a set of contracts) between them has positive value for the second. If B then defaults, one of two things can happen, with an equal economic effect. Either:

1. A pays B the current (net) value of the derivative(s) and B returns the collateral; or
2. A does *not* pay what it owes on the contract(s) and B keeps the collateral, to make up for that.

As the economic effect of either outcome will be the same, the parties will be indifferent as to which applies. Either way, the collateral amount offsets the amount payable on the derivative(s). B may even have posted that collateral on with another party (“rehypothecating”⁶ it to “C”, to secure a separate exposure towards C). In this situation, A is no worse off, since it can simply point to the original transfer of collateral to B and withhold payment on the derivative. Nor is B disadvantaged by that withholding, since it has had use of the collateral

⁶ We attach a note from counsel on the legal aspects of rehypothecation.

to reduce the amount that it must pay to C. In these scenarios, therefore, whether or not collateral is retrieved is moot.

This is entirely different from the situation where entity “X”, as the owner of some securities, lodges them with a broker acting in a custodial capacity (as some investors’ did with Lehman Brothers). In that instance, the usage of those securities by the broker (say, to secure exposures it represents to third parties) should be subject to a clear agreement on the part of X, giving it the legal right to recover those securities in the event of the broker’s default.

There is one final consideration, regarding the use of collateral to secure OTC derivative exposures. If, for some reason in the A-B example above, B has required collateral from A in excess of the amount that A owes it on the contract(s), then A faces a different situation. At that point, it is not indifferent to B retaining the collateral upon B’s default, since the collateral’s value is greater than what A owes B on the derivative(s). At this point, A will become an unsecured creditor for any amount in excess of what it owed B on the derivative(s), and will be very much concerned about how to retrieve it. Note however, that it is only concerned about that excess amount—not about the whole amount of collateral posted.

Right of use of security assets (so-called “re-hypothecation”)

You have asked for a brief summary of the use, advantages and disadvantages of the right of use of security assets by a secured party in the financial markets. This is sometimes referred to as “rehypothecation”, although strictly speaking this is a misnomer, for the reasons given in the Annex to this memorandum.

Article 2(m) of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2000 on financial collateral arrangements (the FCAD) defines “right of use” as “the right of the collateral taker to use and dispose of financial collateral provided under a security financial collateral arrangement as the owner of it in accordance with the terms of the security financial collateral arrangement”.

The purpose of a right of use

Article 5(1) of the FCAD provides that Member States shall ensure that a collateral taker is entitled to exercise a right of use in relation to financial collateral provided under a security financial collateral arrangement. This right of use was one of the most striking and important aspects of the FCAD, as, prior to the implementation of the FCAD, a secured party under a security financial collateral arrangement in virtually all European jurisdictions was either prohibited from using the secured assets or was only permitted, subject to strict conditions, a limited right to re-pledge the secured assets.

This remains true throughout Europe where a security arrangement falls outside the FCAD, and is a natural consequence of the fact that a security taker is not the full owner of the security assets and therefore cannot pass full title to the assets to a third party without the permission of the security provider and without extinguishing the security provider’s ownership interest and therefore the security interest (which is itself dependent on the security provider’s ownership, being a partial interest carved out of that ownership).⁷

The Member States recognised, however, that in the context of financial collateral arrangements, the inclusion of a right of use in security financial collateral arrangements, if agreed between the parties, promotes liquidity: see Recital 19 of the FCAD. Liquidity and the free circulation of financial assets is important for market efficiency and systemic stability.

The right of use is not relevant to title transfer financial collateral arrangements, including under an English law ISDA Credit Support Annex (Bilateral Form — Transfer) or under a securities lending or a securities sale and repurchase (repo) transaction, because the right of the transferee to use the assets transferred under such an arrangement arises from the nature of the arrangement. The transferee becomes the full owner of the assets and is therefore free to deal with them as it sees fit. The transferee has a contractual obligation, normally, to transfer fungible equivalent assets to the transferor at some future date, but is not required to return the exact same assets it originally received. The securities lending and repo markets have functioned efficiently on this basis for the past thirty years. It is perhaps worth noting that the majority of financial collateral arrangements in the European market are effected on a title transfer basis and a large proportion of those are documented under the 1995 ISDA English law Credit Support Annex (Bilateral Form—Transfer) (the ISDA Transfer Annex).

⁷ In theory, a third party might agree to take the transfer of an asset subject to the security taker’s security interest, but that would not normally happen in relation to financial collateral. A purchaser of securities under a securities sale or repo transaction expects to get title free and clear of any other person’s interest.

The advantage of a right of use

As noted above, the inclusion of a right of use in a security financial collateral arrangement promotes liquidity. A secured party with a right of use, if able to deal with the collateral assets, is able to use them more efficiently, (a) reducing its own need to acquire assets for delivery into other collateral arrangements where it is a collateral provider as well as (b) allowing it to generate profit through trading the assets, in turn enabling it to offer lower prices to the collateral provider for its services relating to the collateral arrangement. The right of use, in other words, benefits the collateral taker, the collateral provider and, due to the additional liquidity it provides, the market generally.

The disadvantage of a right of use

Where a secured party exercises a right of use, the security provider normally has only a personal right to redelivery of assets equivalent to the assets it originally provided under the security arrangement. In other words, the security provider is in the position it would have been in had it provided the assets under a title transfer arrangement. This means that after a right of use is exercised, the security provider has no continuing proprietary interest in the security assets it originally provided. If the secured party becomes insolvent, the security provider becomes an unsecured creditor for the value of the security assets originally provided.

A carefully drafted security arrangement that includes a right of use will provide that the security provider has a right of set-off allowing it to set off the value of the security assets provided (where the right of use has been exercised) against the secured debt owed to the secured party. As part of its normal legal due diligence, the security provider will want to assure itself that the set-off is effective against the secured party in the event of the secured party's insolvency.

Thus the credit exposure of a security provider to the secured party is normally limited to the excess (if any) of the value of the security assets over the secured debt. Economically this is the same as the position of a transferor vis-à-vis an insolvent transferee under a title transfer collateral arrangement or securities lending or repo transaction (or master agreement). The credit risk of a security provider to a secured party under a security arrangement including a right of use is something that the security provider can manage, for example, by ensuring that it monitors the level of collateral it provides and promptly calls for excess collateral to be returned.

Credit risk management of this type occurs on a daily basis in the OTC derivatives market in relation to title transfer collateral provided under the ISDA Transfer Annex as well as in the securities lending and repo markets. It is a familiar and easily understood form of credit risk that may be managed in a straightforward way.

Conclusion

There is, of course, a balancing act to be performed between the greater protection that a security provider has in relation to the security assets it provides if a right of use is not permitted and the greater efficiency and cost-effectiveness (from which, normally, the security provider benefits through more competitive pricing from the secured party) of arrangements permitting a right of use. How the balance is struck will depend on all the relevant circumstances in each specific case, but liquidity and market efficiency certainly leans toward permitting a right of use in the wholesale financial markets for the vast majority of ordinary trading operations.

It may be worth noting that the right of use has been a feature of the New York law of secured transactions under Article 9 of the New York Uniform Commercial Code for much longer than it has been available for the European financial markets under the FCAD.

Annex**THE MEANING OF THE TERM "REHYPOTHECATION"**

The term "rehypothecation", as a legal term of art, strictly means only re-pledge. A right of rehypothecation is, in other words, a right of a pledgee to repledge security assets. Many European jurisdictions allow a pledgee this limited right, subject to strict conditions, but, except where the FCAD applies, do not allow any other use of the security assets. Thus, even where a right of rehypothecation (in the strict sense) is permitted under local law, a pledgee normally has no right to sell or otherwise transfer title to security assets to a third party purchaser free and clear of the interest of the original pledgor.

It is for this reason that the FCAD itself avoids the use of the term "rehypothecation" and instead in Article 5 provides that a collateral taker under a security financial collateral arrangement has a "right of use", as defined in Article 2(m) of the FCAD.

In commercial usage, however, the term “rehypothecation” is often used in the broader sense to mean a right of use. This can lead (and has led) to unfortunate misunderstandings between international banks and local counsel in jurisdictions that permit rehypothecation only in the strict legal sense. The term is best, therefore, avoided in careful discussions of the issues raised by a right of use, however this can be difficult in practice when discussing this issue with non-lawyers. Of course, difficulties do not necessarily arise provided that everyone involved in the discussion understands that the broad sense of the term is meant.

February 2010

Memorandum bu LCH.Clearnet Ltd

1. INTRODUCTION

1.1 LCH.Clearnet Ltd (hereafter referred to as “LCH.Clearnet”) is the world’s leading independent CCP clearing house, serving major international exchanges and platforms, as well as a range of OTC markets. It clears a broad range of asset classes including securities, exchange traded derivatives, energy, freight, interbank interest rate swaps and euro and sterling denominated bonds and repos; and works closely with market participants and exchanges to identify and develop clearing services for new asset classes. It is part of the LCH.Clearnet Group, together with its sister CCP LCH.Clearnet SA, based in France, which is developing a clearing service for Credit Default Swaps. The LCH.Clearnet Group is predominantly user-owned (83%, with the remaining 17% owned by NYSE Euronext and the London Metal Exchange). LCH.Clearnet is a Recognised Clearing House supervised by the Financial Services Authority.

1.2 LCH.Clearnet is uniquely qualified to comment on the Commission’s proposals as the operator of SwapClear, the clearing service for OTC interest rate swaps. Established for over 10 years, it now clears approximately 60% of the inter-dealer market and has recently extended its reach to the buy-side. It successfully managed the default of Lehman Brothers in September 2008, closing out a portfolio of some \$9trillion without causing disruption to the market.

1.3 LCH.Clearnet is broadly supportive of the Commission’s aims of improving systemic stability through greater use of CCP clearing services, strengthening the safety and soundness of CCPs, and ensuring robust risk management and appropriate regulatory supervision of all OTC derivatives, whether cleared or not. However we note below a number of concerns over the details of the proposals as they emerge. These are noted in our answers to the specific questions below.

2. DERIVATIVES

What economic benefits do derivatives bring?

What risks are associated with derivatives and derivatives markets?

What role did derivatives play in the recent financial crisis?

2.1 We support the views expressed by the FOA in its submission, in particular that the mainstream OTC markets were not a cause of the crisis. The impression sometimes given by some policymakers is that (some) derivatives should be outlawed or at least driven out of Europe. Such intent runs the risk of seriously damaging economic growth: see for example the recently-published Federal Reserve Bank of New York Staff Report “Policy Perspectives on OTC Derivatives Market Infrastructure”:

“Although many risk-management solutions are available through exchange-traded derivatives, end users would have limited ability to obtain derivatives that are customized to their specific needs. As a result, corporations and other investors would be unable to offset certain types of business risks caused by fluctuations in currency prices, interest rates, default risk, and energy prices, among many other sources of financial risk that they may wish to control. Indeed, while most large corporations hedge some risks using exchange-traded derivatives such as futures contracts, they often rely on OTC derivatives to hedge those risks for which there is no close match available on organized exchanges, and to satisfy hedge accounting standards.

Remaining unhedged can be costly. For example, if unable to hedge effectively, managers may choose to avoid some projects whose uncertain cash flows have a high net present value for their shareholders out of fear that losses resulting from unhedged risks could be misperceived by their shareholders or superiors as a reflection of poor project selection or management. A failure to hedge can also increase the probability of bankruptcy, or at least financial distress, which brings additional costs, such as legal fees or high frictional costs for raising new capital when distressed.

Without the opportunity to use the OTC derivatives market as an incubator for new financial products, the development of many new types of derivatives would be stifled, limiting the potential for financial innovation to spur economic growth.”

3. CLEARING DIRECTIVE

Should CCPs be supervised at a national or EU level?

3.1 The level at which supervision is performed (ie whether European or national) is less important than the competence and powers of the supervisors. Moreover we emphasise the need for regulatory co-operation between all supervisors, whether national, European or in third countries, as CCPs and OTC derivatives markets in particular are rarely limited in their geographic scope to any single jurisdiction or currency zone. The example of the supervisory structure that is in place for the LCH.Clearnet Group, involving regulators from seven countries, and for CLS bank—necessarily an international framework—can serve as a basis for wider application. While supervision might be undertaken using a Europe-wide college style approach it is important that, when managing a crisis especially a default, there is a lead regulator with both clear responsibility and authority. Therefore, this aspect of supervision should remain at the national rather than the EU level.

What benefits will a Directive at EU level bring?

3.2 We note at the time of submission that it is not yet clear whether the legislation will take the form of a Directive or a Regulation. While we support higher standards, more rigorously enforced, and EU-level legislation should help prepare a level playing field, commercial and political obstacles to cross-border provision of services are likely to remain, such as have contributed to the lack of progress in establishing more “interoperable” CCP links. Therefore while we are in principle in favour of EU-level legislation, we are doubtful about the extent to which the situation will improve with respect to enabling CCPs to provide services across borders. As the changing interoperability debate has indicated, risk considerations must trump competition considerations, particularly in relation to wholesale risk and CCPs. This must remain clear in any European legislation which is enacted and there must be room for pragmatic risk management to take place without being constrained by overly theoretical competition considerations being imposed by the legislation.

What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?

3.3 We assume the question refers to OTC, rather than exchange-traded, derivatives markets. At a high level there is no difference to the overall risk management approach that should apply to CCPs clearing securities, exchange-traded, or OTC derivatives. Existing international principles at global (CPSS-IOSCO), European (CESR-ESCB) and national levels are applicable to all types of instrument. The main difference for OTC derivatives is that, by definition there is no central marketplace although for example supervisors will need to give particularly close attention to the determination of prices for margin calculation; and this has most relevance when a CCP finds itself having to manage the default of a participant (as LCH.Clearnet did for Lehman). An instrument cannot be deemed eligible for clearing unless a default can be managed without disrupting the trading positions of the surviving participants. Without a central marketplace therefore, it is necessary to have in place robust arrangements with market participants to manage the orderly close-out or transfer of positions. These should be backed up by emergency powers that can be independently exercised, and adequate governance arrangements that should serve to ensure those powers are used appropriately. This reinforces the position that, provided that appropriate governance arrangements are in place, CCPs must be the ones to decide what is, and what is not, eligible for clearing,

3.4 We would be concerned if the Commission attempted in its primary legislation to be overly prescriptive about the details of how margins and other risk management mechanisms (such as default funds) should be calculated in an attempt to force all CCPs into the same mould. A CCP’s risk management framework (eg payment and default management arrangements, legal structure, registration mechanisms, systems capacity, price and positions availability—all of which drive the underlying risk management approach, not just the quantification of market risk) is peculiar to itself and its own risk appetite, which varies from one to another. It may be possible to provide more guidance on factors to be taken into consideration when designing and assessing such mechanisms, but we believe this should be undertaken by the supervisory authorities in close conjunction with the CCPs and industry, not by the Commission.

Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?

3.5 We welcome the Commission's emphasis on eligibility rather than standardisation. Instruments that are eligible for clearing by a CCP may or may not be "standardised" (depending on the definition of "standardised"), but not all "standardised" instruments will necessarily be eligible for clearing. The fundamental requirement for eligibility is that the CCP can manage the default of a participant, through the implementation of both its risk management and default management policies, in a way that controls systemic risk. The main considerations are these:

- (a) Can sufficient liquidity in the market (or related markets) be assured, such that proprietary positions of an insolvent participant can be closed out in the market under all but the most extreme scenarios?
- (b) Are market prices available and reliable such that they can be relied upon as the basis for calculating market risk and therefore margin and other collateral requirements?
- (c) Does the CCP have robust and workable default management procedures to effect closing out in the market?
- (d) Can the clearing service and maintenance of risk management structures to withstand participant default be provided at an economic cost?

We do not comment on whether MiFID is the appropriate text in which to address the issue of mandatory clearing.

3.6 We have a concern that a regulatory structure whereby it is (even after some reasonable period of time) mandatory to clear a particular derivative will serve to exacerbate the first-mover advantage effect that already exists in the clearing market which is characterised by network effects and economies of scale. In principle the proposal appears to envisage that the first European CCP to launch a service in a particular derivative will rapidly capture the entire market and obtain a significant competitive advantage over any newcomer. Apparent harmonisation of risk management principles and even the existence of ESMA is unlikely to ensure that the first to market is necessarily the best, either in terms of risk management, efficiency, or cost.

3.7 Requiring market participants to extract clearing-eligible derivatives from master netting arrangements that include ineligible derivatives may lead to an increase in exposures and systemic risk. Market participants should be allowed to retain bilateral relationships (ie not clear certain transactions) if it can be demonstrated that this serves to reduce overall risk.

3.8 CCPs and their participants, who bear the risk of the clearing activity, must retain the right to decide what is, and what is not, eligible for clearing, not a regulatory body. In this connection it should be noted that one of the key criteria for determining eligibility is the degree of liquidity of the product in question. This may vary over time, and a product that may be eligible for clearing under certain conditions when launched may require changes to its risk management approach should liquidity decline, or even become ineligible. CCPs must be able to make these determinations, however we recognise a legitimate role for supervisory authorities in ensuring appropriate market coverage.

Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?

3.9 Yes, and it must be ensured that where there are potentially uncapped liabilities incurred by participants, for example through assessment mechanisms available to a CCP to call additional funds from surviving participants in excess of their own margin and default fund contributions, this should be reflected in the supervisory treatment of exposures to CCPs. Specifically, while an exposure value of zero for Counterparty Credit Risk *can* be attributed to exposures to CCPs, this may not adequately reflect the true potential exposure if they are liable to further potential losses arising from the failure of another user of that CCP. In all cases, capital charges must be proportionate to risk and not penal.

3.10 A particular concern for the UK derives from the regulatory encouragement for CCPs to make the greatest possible use of central bank payment facilities, which might be viewed as a factor to be assessed by supervisors when assessing whether to recognise exposure to that CCP as meriting the zero treatment. There is a risk that unless a CCP has direct access to central bank facilities in a certain currency, some supervisors might not permit the zero treatment and lead participants either to keep derivatives outside of CCPs or to make use of a domestic CCP. While we support any measure to improve the robustness of CCPs' risk management processes, there are technical, legal and political barriers that stand in the way of a CCP having access to foreign central banks' settlement and liquidity facilities. This is likely to impair the ability of a UK-based CCP that provides services in foreign currencies from competing on a level playing field with foreign CCPs that are able to make use of their own central bank's facilities.

4. FURTHER ISSUES

Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?

4.1 Although there currently seems to be no intention by the Commission to the proposal passed by the US House of Representatives to limit the extent of bank/dealer ownership of CCPs, we take this opportunity to make the point that the close alignment of interests between the CCP and its participants, who alone have the expertise to judge how to risk manage a product, means that ownership of a CCP by those who bear the risk is in fact the preferable model and should be encouraged rather than prevented. If participants' ownership interest were subject to limits, they would have little incentive to participate in the creation and development of their products and services and less ability to influence its risk management policies and practices. Conflicts of interest can be, and are, addressed much more effectively through ensuring appropriate processes governing the structure and deliberations of a CCP's Board and Risk Committee.

5. SUMMARY

While in general we fully support global supervisors' efforts to reform financial markets, ensure greater stability and reduce systemic risk, many of the specific proposals will need further careful analysis and consultation. We also have a concern that the various initiatives taking place within the main jurisdictions (the EU and US) and at the global level may not be fully co-ordinated and as a result there is a danger that regulation may lead to conflicts, overlaps and distort the competitive dynamic to the detriment of the UK.

1 February 2010

Examination of Witnesses

Witnesses: MR ROGER LIDDELL, Chief Executive, and MR RORY CUNNINGHAM, Director of Public Affairs, LCH. Clearnet, examined.

Q99 Chairman: Mr Liddell and Mr Cunningham, a warm welcome; it is good of you to give us your time today. Could I remind you that in front of you are the declarations of interest of the members of the Committee, and I need to add to those the apologies of Baroness Cohen, the Lord Chairman, who is not able to be here today. She asked me to declare an interest on her behalf as non executive director of the London Stock Exchange, a subsidiary company of Borsa Italiana, CC&G, which is a clearing house for everything traded by Borsa Italiana, and also for EDX Derivatives based in London. Is there anything you would like to say by way of introduction before going into the questions?

Mr Liddell: I do not think so.

Q100 Chairman: We asked the previous witnesses if they were able to explain to laymen very simply and briefly—it may not be possible—what derivatives are?

Mr Liddell: I was listening to the previous session so I heard the conversation and I think the example that was given is probably the best one, which is basically the derivative is a means of either gaining exposure to or gaining an offset to an underlying asset without either buying or selling the underlying asset, so that can be currency, interest rates, a commodity—a whole list of things, but it is a means of gaining or reducing exposure without buying or selling an underlying asset.

Q101 Lord Trefgarne: Can I start by asking whether you could briefly describe the roles of the CCPs in a derivative contract? How does it work?

Mr Liddell: Basically what happens is the two parties will enter into a transaction with each other, a bilateral transaction, and then the transaction is submitted to the central clearing house, and that one transaction is effectively replaced with two transactions where the central counterparty stands in and becomes the seller to the buyer and the buyer to the seller, so that means that each of these two counterparties will be able to trade in whatever instruments they are trading in with all of their counterparties. To the extent they are all members of the clearing house effectively at the end of the day that trading house only has one counterparty for all of its trades, which means that all of its trades in a given instrument or a given currency or a given security all net down to just the net of the activity they had had in that given day. So the counterparty effectively reduces the level of activity and nets down all the risk, and then stands in the middle and applies margin and takes collateral from each of the counterparties.

Q102 Baroness Northover: There are plans to increase the proportion of derivatives that are centrally cleared. Can CCPs help to reduce financial instability and systemic risk, and, a very similar question, if more of these products are cleared centrally, does this reduce the overall risk that derivatives pose themselves in the financial system?

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Mr Liddell: Certainly central clearing of derivatives reduces risk very significantly. As to whether it would prevent instability or increase stability, that is a more complicated question, I believe. Certainly having access to information for regulators and having more transparency will at the margin help instability, but I think it would be misleading to argue that clearing in and of itself would reduce instability. Does that make sense?

Q103 Baroness Northover: I am surprised, that is all.

Mr Liddell: The reason I am saying that is that a given firm can take the level of risk it wants to take, and putting its transactions all through central clearing house does not reduce the level of risk that that has got. What it does is reduces the level of risk that that counterparty would represent to all of its counterparties, so it reduces the consequence of a defaulting member on others but it does not reduce the probability of a member defaulting.

Baroness Northover: Obviously the size of the CCP may have an effect as well, but we will no doubt come to that in a minute.

Q104 Lord Trimble: Focusing on the number of CCPs, should that number be determined purely by market forces? Is it important that some clearing houses are based in the EU, and does this raise any policy issues for the EU or the UK?

Mr Liddell: I think the role that central counterparties will increasingly be playing, particularly in OTC derivatives, is so important that there is a question as to whether, over the longer term, these activities should be just allowed to be managed as normal commercial activities, given the systemic dependence that the financial markets have on them. We certainly believe that central counterparties need to be increasingly highly regulated. As to the physical location, I think it depends. There are some financial markets which are domestic markets, securities markets typically, equities markets, where it makes a lot of sense for the clearing house to be in the country where these stocks are listed and traded, but increasingly the over-the-counter derivatives markets are global in nature, many of them, and as such it should not be that significant where the clearing house is located. The interest rate swap business is by far the largest OTC derivative market; it is huge. As one of the previous witnesses said, we have over \$100 trillion notionally in it now, it is actually \$200 trillion because we split the trades into two, which is a massive amount of activity. About 60% of all of the global inter-bank interest rate swaps activity comes through our UK entity. There is a huge amount of benefit in terms of having all that risk in one place in terms of efficiency and in terms of risk reduction. If that were to be split out into different jurisdictions based on currency that would be bad for the market,

but what that means is that we already here in the UK have a single clearing house that has a massive proportion of the global trading activity in the largest OTC derivative asset class, and what that means for us in turn is that we increasingly need to adapt the way we operate to suit the needs of a global market place, and that means that we have formal relationships with lots of regulators in Europe and with the CFTC in the United States. Separate to that, however, we have informal relationships with other regulators that have no direct jurisdiction over us, but we believe that if we are active in currencies that are important in other countries, obviously, then we need to have relationships with central banks and other constituents. The most desirable outcome of that would be to have clearing as a highly concentrated activity, because the fewer clearing houses there are the more benefit from this offsetting and netting you get, but they need to be very highly regulated and controlled, and on a global basis, especially if they are going to be active in global markets, there needs to be co-ordination and co-operation between regulators in different jurisdictions. For example, on the question how would the Government of Greece feel if there were people taking large negative positions in their debt, I can imagine the Government in Greece and the regulators might have a strong interest in that. The obvious answer to that is, if that activity is being cleared somewhere else, like for example in the UK, then the UK regulators and the Greek regulators need to have an understanding as to how to operate, and a logical consequence of that could be that we as a central counterparty may be required to provide data to the Greek regulators so that the Greek government could get the same supervision that it would have if it had its own clearing house, as an example.

Q105 Chairman: We have been told for ages to distinguish between regulators and supervisors, regulation and supervision, and I think you were talking about supervisors when you used the word “regulators” there in our language.

Mr Liddell: Yes. It is the same people operating in a supervisory capacity.

Q106 Lord Trimble: You said that the market in interest is \$100 trillion or \$200 trillion and that 60% of that is handled through a CCP in London. Does that pose any serious risk? Could this go pear shaped with the Government having to think about bailing out some of this? It is a huge sum of money.

Mr Liddell: It is a fascinating question. My honest belief is it does not but there is a fact that all of this risk is concentrated in one place but the risk then is reduced dramatically, and it is important to understand just in basic terms the waterfall of

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measures we have available to us. We have our own capital, for example, which is just over 300 million EUR. The default fund that the previous witness was talking about is the default fund that we are managing that is capital provided to us by all of our members on a proportionate basis. That currently stands at around £600 million, so those are both important measures, and there are other smaller measures as well which I will not refer to. However, on a day-to-day basis on which we are managing all this activity, we are re-calculating the values of all of the transactions we have obviously all the time, and any movement in value, positive or negative, would result in us either calling or releasing collateral equivalent to that value, which means that at any point in time every one of our members has effectively a neutral position. If they were to disappear and everything was to be dissolved then there would be no financial impact on us as a clearing house because we have already realised the change in value through the margin process. That is variation margin. The most significant measure we have, however, is what we would call initial margin; variation margin is market-to-market based on changing prices. Initial margin is the margin that we call based our view of the level of risk that that member has in that activity, and initial margin is huge. So, again, the capital base we have is just in excess of 300 million EUR, the default fund is around £600 million, the total amount of initial margin that we are holding on behalf of all of our members based on the level of risk that we think they have is more than £50 billion, which is the first line of defence. If a member goes into default, before all of these other resources are tapped into, we have all of the defaulting members' initial margin that we took because of the risk that they had, and in the case of Lehman Brothers, if I can give you some numbers, at the time they went into administration we had about \$2 billion of initial margin of theirs, so putting aside that we would mark to market all of their transactions, we effectively had had them pre-fund \$2 billion of losses that we would then potentially incur as we liquidated their portfolio. In the event we used about 35% of that and the rest was surplus that was released, so only 35% of the first measure was used; the default fund was not tapped into at all; our own capital was completely secured; even the Lehman Brothers' contribution to the default fund was not incurred, and we had insurance as well that was not utilised. So yes, having all this risk in one place in theory could present a problem, but if it is managed in an appropriate way, it certainly should not do.

Q107 Baroness Northover: Can I follow up on that? That works well if you only have one major defaulter, as it were, but supposing you have, as happened, a whole system seeming to implode. What is the proportionate value of the collateral which you are

holding there compared with the value of the trades that are going through?

Mr Liddell: It varies. The level of initial margin that we call is a function of the level of risk that the member has and also of the current level of volatility in that instrument and the historic levels of volatility in the instrument.

Q108 Baroness Northover: But all those things were what was unknown in this past crisis—the level of risk, the level of volatility, all those things proved to be unknown—so if you were to look at it now, you have given us some figures of what you hold in terms of your own capital and the collateral that you hold, how does that relate in terms of proportion to the volume of trades that are going through?

Mr Liddell: To answer the first point first, not all of those things were unknown. There were a lot of things that were unknown but one of the things that had been happening in the weeks and months building up to the Lehman Brothers problem was that volatility was increasing so the level of margin we were calling was increasing, not just for Lehman Brothers but all of our members depending on which asset class they were trading in. So this is not a static calculation; this moves up and down depending on the level of risk and depending on the activity in the market. We also run stress tests on the default fund regularly which basically are designed to see whether our default fund could withstand the default of our biggest member at any point in time under stress conditions, so we use all sorts of scenarios going back over the last twenty years of any shock of any sort in any financial market and look at the effect that had across all of the asset classes we have and then run that against our current portfolios, so we are always doing a lot of stress testing and scenario analysis and then adjusting for current levels of risk. I do not think it is possible just to give you a proportion but, again, the total amount of collateral we have on initial margin is around £50 billion and, as I say, in Lehman's case it was about \$2 billion; the size of their interest rate swap portfolio which is where the most risk was, was \$9 trillion notional, I think we had about £230 million sterling against \$9 trillion of notional.

Q109 Baroness Northover: So are you stress testing not just assuming the collapse of your biggest dealer but a whole series of your big dealers?

Mr Liddell: Not a whole series of big dealers but we are stressing against a marketwide shock and the default of the biggest member, and we assume that if the biggest member were to go down there would be some small ones as well. If you are asking could we stand all of our members defaulting we probably could not, but on the other hand, however, having gone through that real life experience, which

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obviously was very valuable to us and we are delighted with the way it went, it also gave us a chance to learn a huge amount of really valuable lessons which we have been able to use to improve our risk management ability, so not only are we very happy with the way it went but we feel in much better shape now, and we hope it will never happen but we have been doing some analysis internally to plan for how we would operate if we had two or three of the biggest members default at the same time—or nearly at the same time because you can imagine it probably would not be simultaneously but sequential, in which case you are halfway through an exercise and you have to stop so it gets very complicated, but that is exactly the sort of thing we look at.

Q110 Chairman: Do you think there is a potential problem regarding the segregation of margins paid to CCPs and the segregation of collateral paid to counterparties in OTC derivative transactions?

Mr Liddell: Yes, I think there is.

Q111 Chairman: What is the problem, and what is the solution?

Mr Liddell: There are, or were, at least two problems in the Lehman Brothers case. The way the futures market works in general is we have a clearing member who will be trading on its own account, hedging its own book, whatever it chooses to do, who will also be clearing on behalf of its own clients, so it has two accounts with the clearing house, house and client, and client is an omnibus account where all of their clients are effectively in the same account. So the first problem we had was we learnt that a lot of the customers, particularly the overseas customers of Lehman Brothers, had chosen to opt out of the UK client protection regime which meant their assets, their positions, were effectively co-mingled with Lehman Brothers house and were not separately identified and managed in the client account. That was a huge problem for us, first, because it meant we did not know exactly what the clients' positions were and could not start hedging the house account, so that causes all sorts of issues which have been dealt with now by the FSA and the Treasury, and there are matters in hand to take care of that. The other two issues, however, were that in the UK regime the clients in this omnibus account are margined on a net basis, which means the total value of collateral that the clearing house takes from the clearing member in respect of its clients positions is the net of all of the client positions rather than gross, so the total value the clearing house would have would be less than individual clients have posted, and the associated problem with that—and, again, we were not directly involved in this but obviously it was an issue in the market—is that the margin that had been posted by those clients to Lehman Brothers was given the same

or very similar treatment to all of the other creditors' positions within Lehman Brothers, which meant that in the futures market, you would imagine all clients would then move to clear through a new clearing member because they still have the same underlying business, they were not able to retrieve, on a timely basis at least, the collateral locked up as part of the whole administrative process of Lehman Brothers, so there are at least two, if not three, problems associated with that. As we are moving to become more active in the over-the-counter markets, just briefly, this concerns us a lot in terms of us expanding our clearing for derivatives for clients. The business we have at the moment is an interbank business. We have now started clearing for clients and have developed an entirely new regime which gives clients a different level of protection. It has not changed the regulation at all, but we have circumvented that by putting a different legal structure in place.

Chairman: It would be useful if you could just do us a brief note on the suggested solutions to it.

Q112 Lord Jordan: Could I ask a point, Chairman, on that, to be included in the note? You said Lehman Brothers did not give you certain information which came out. What advantage was there to them in not giving you that information?

Mr Liddell: It was not so much they had not given us that information; it was that this activity was being managed by them as part of their firm activities, so it was customer information embedded in their systems.

Chairman: Please give us a note on this, because you are saying that was a problem and previous witnesses gave us a rather rosy impression of all of this, and Lord Moser is a little bit suspicious of rosy impressions. Here was a problem, that this nice neat clearing system, CCP, hit a snag, and what we really need to know is what was the snag and what were the solutions to it, because if it happens again and we have not taken any appropriate action there will be a lot of bother.

Q113 Baroness Hooper: You mentioned that certain clients opted out of the protection system. Why did they do it? Was it because of cost?

Mr Liddell: It must have been. These were clients that were trading across a number of asset classes and what they would have benefited from would have been lower margin costs by having offsets all in the same place.

Chairman: Mr Liddell, what we need to know is whether this is a problem and is something needing to be done within the process. Lord Moser?

Q114 Lord Moser: My question goes to the nature of the EU legislation of organisations such as yours. You are the biggest, just as a matter of interest, in the CCP world?

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Mr Liddell: Yes.

Q115 Lord Moser: By a long margin?

Mr Liddell: It depends how you calculate it. The CME in the States being a huge exchange has more activity; we have more risk and more asset classes and cover more jurisdictions.

Q116 Lord Moser: Just as a matter of interest, is the derivatives part of it, the derivative clients, a small proportion of your total work?

Mr Liddell: A very high proportion because derivatives include both the OTC derivatives, which is where the focus currently is, and all of the listed activities, so all of the LME's activity, the LIFFE Exchange, and so on and so forth.

Q117 Lord Moser: Specifically reading your evidence, you are basically happy in general about the EU legislation to create a level playing field on CCP?

Mr Liddell: Yes. In general.

Q118 Lord Moser: I have two specific questions against that background. I think you argue that you do not expect new legislation to improve organisations like yours giving services across the borders.

Mr Liddell: What we are referring to there was more of a feature in the securities markets, more domestic in nature, so we are not optimistic that any harmonisation of rules or any standardisation would make it easy for us to compete in other domestic securities markets, which is separate and distinct from the derivative markets where I think they are global in nature and we will be able to compete, and are able to compete.

Q119 Lord Moser: I am sorry; I have not quite understood. If it is across borders, what is your answer on that?

Mr Liddell: If it is across borders in securities like in equities then we are not optimistic that it will be fully harmonised and we do not think we could get access. We do not have the same concern in derivatives.

Q120 Chairman: This is in the European Union?

Mr Liddell: And in the United States as well.

Q121 Lord Moser: The general question is what kind of regulation do you expect the EU to focus on in terms of minimum standards and so on?

Mr Liddell: It is important that minimum standards are addressed. However, they are likely to be very broad in nature because a clearing house needs to determine itself what level of margin to call from its clients, and it would be a mistake to try and legislate for how you would numerically calculate that.

Q122 Lord Moser: Could you give examples of what you mean by minimum standards?

Mr Liddell: Yes. We have a situation at the moment whereby a small more recent competitor of ours is unhappy because they are charging much higher rates of margin on some equity transactions. We are charging what our calculations tell us we should charge. What we benefit from is having a large portfolio of activity with those clients so we have natural offsets, so if you have two clearing houses, one that might have multiple asset classes and clients trading across all of them, then in any given asset class they are likely to require less margin than a single purpose clearing house would, so that is part of our concern.

Q123 Lord Moser: Were you implying, or not, that the margins are regulated?

Mr Liddell: The regulators and supervisors need to be comfortable with the standards being applied by the clearing houses.

Q124 Lord Moser: But your competitors might charge differently?

Mr Liddell: They do, and sometimes they complain about that because they think we have an unfair advantage. If a clearing house is using margin simply to compete and taking more risk, then that would be a bad thing—I am not sure it has ever happened but in theory it could—whereas a clearing house that has the benefit of a lot of mutualised risk and a broad portfolio should be allowed to reflect that in terms of passing on their deficiency to its members.

Q125 Lord Moser: Do the clients shop around? Do they come to you to see what you charge and to the competitors?

Mr Liddell: They could do. We do not see much evidence of that happening. In some markets it is a very limited possibility, but it is possible.

Lord Moser: Interesting world! Thank you.

Q126 Baroness Hooper: The European Commission in its communication has suggested providing incentives to make products clearing eligible. Do you think they should do this, whatever “incentives” means in this context, of course, and perhaps you would also explain what makes a product clearing eligible.

Mr Liddell: First, I absolutely am very strongly in favour of them creating incentives to encourage more centrally cleared activity, and usually the formula that takes is by more favourable regulatory capital treatment. I would, however, prefer to view that as being more favourable treatment with netted activity as opposed to penalties attached to non-netted activity. An incentive is better than the opposite. In terms of what is clearable, it is hard to prescribe but

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clearly there needs to be good available pricing data and good pricing history. There also needs to be a degree of liquidity, and the way we see it the question is really not what is eligible for clearing but what is eligible for default management, because you can have a market that can function very well day in day out, be highly liquid, like some of the credit derivative markets are, but it is possible that when you get towards a default situation, that liquidity, because of stress on that underlying name, might dry up, so you need to be really comfortable that the market is not just liquid today but will remain liquid, or there will be something that will replace that liquidity as a means of establishing a price to margin and to net off. We also do not believe that transactions have to be standardised necessarily to be cleared. It is easier if they are standardised, but the swap portfolio we have is simple and vanilla in its risk but is not standardised in terms of transactions. They are pretty much all different. We also think, however, that there is too much focus at the moment on what is eligible for clearing. The reality is there is a huge amount of OTC derivative activity at the moment that can be cleared and we think should be cleared, and we think that we should all get on trying to find a way of doing that more quickly and then worry later about where we draw the line in terms of how far we go, and that line will continue to be moved as commoditisation improves and as new products come into the mix. So I do not know where the end game will be, but certainly there is a lot of activity out there today that could be cleared.

Q127 Chairman: Why is it not? The previous witness gave me the impression that it was self-evidently in the interests of somebody to go into clearing and it did not need any explanation. You have just said there is a lot of business out there that does not go through central clearing, although it perfectly well could.

Mr Liddell: It is just not his business. The service we currently have in swaps is an interbank business, so each of the banks that trade with each other submits pretty much all of their trades to us. So the comment he made I agree with, that the banks are strongly incentivised today to clear everything they can clear but their clients are not. We have only just launched a client clearing service for interest rate swaps. Nobody else has it. Until today clients have not had the mechanism for having their trades cleared, so there is a huge market out there that we are keen to tap into.

Q128 Lord Marlesford: What is the difference between the American and the European approach to the regulation of the derivatives markets?

Mr Liddell: For listed derivative markets there are lots of differences. Basically there is a specific legal framework in place in the United States that covers

listed derivative markets which then are all covered by a separate regulator, the CFTC, so the entire legal basis is different. It has many features, probably some I am not familiar with but the main ones are that the entity that is the clearing member has to be a futures commission merchant under United States law and has certain obligations to the clearing house that would not exist anywhere else, and there is a specific carve-out into the bankruptcy treatment for the handling of the margin collateral that has been posted under that regime. It effectively can get accelerated treatment around the bankruptcy proceedings.

Q129 Lord Marlesford: Very slightly going back to what you were saying when you were answering Lord Moser, when you mentioned you keep an eye on everything and you use the mark to market process, when one big client goes wrong, does mark to market not involve downgrading a lot of the assets held by the others? After all, the essence of the credit crunch was when in the SIVs the bad debt was concealed, suddenly realised, and everything had to be marked down. What is the protection against that?

Mr Liddell: We have to anticipate volatility in markets and that is why we hold all of the collateral on behalf of all of the members, not just the one that is defaulting, and over the first week of the Lehman Brothers default we had massive dislocation in markets. On the Wednesday we had a massive amount of interest rate movement caused by AIG. All of this had a huge impact on all of the rest of our clients and a big impact in terms of the margin we had to increase and call, so basically we just have to monitor it all the time and any time the risk goes up or the values go down we just take more money from them. Intraday, if necessary.

Q130 Lord Marlesford: But then you are going to push some people into going bust as a consequence of the original people going bust?

Mr Liddell: We have to be intelligent as to how we protect the clearing house and its members and make sensible calculations as to the level of risk we have and charge what we think is an appropriate charge. In the margin there is a possibility that the first default of a member could be to its clearing house but, again, the level of collateral that it will post to a clearing house would almost always be less than the sum of the collateral it would be posting bilaterally if it did not have it all in one place.

Q131 Lord Marlesford: So an EU regulation really only helps insofar as it prevents the original toxicity, if you like?

Mr Liddell: I do not think there is anything in the likely EU regulation that would have reduced the problem associated with sub prime mortgages, for

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example, and the packaging up of CDOs and all sorts of other asset classes; I do not think there is anything that would specifically prevent that.

Q132 Chairman: In what circumstances could a CCP collapse, or require to be bailed out?

Mr Liddell: It could collapse if it had seriously miscalculated the level of risk that it had in its portfolio, so in the event we were to use all the initial margin up, in Lehman Brothers' case the \$2 billion we had, and still have assets on the books that were not liquidated, if we were then to use all the default fund, the £600 million, then we are into our own capital, and if we then went through our own capital we would be insolvent, so it is possible, but our entire reason for existing is to avoid it happening.

Q133 Chairman: So at the present time you do not think there are any financial instruments out there, as there turned out to be in different circumstances two or three years ago, that are not really genuinely fully understood to be risks?

Mr Liddell: By the banks?

Q134 Chairman: By yourselves.

Mr Liddell: We are very comfortable with what we have, what we clear, but we do not clear the toxic stuff I referred to before; that would probably always fall outside that which we were comfortable to clear. It is possible some of it might be cleared, but only if we felt comfortable that we understood the risk associated with it.

Q135 Lord Jordan: To refer to that unlikely calamity, does this mean that CCP should be supervised at national level, and, if that calamity did occur, what would happen if it was not a country like this but a small country? Could it be bailed out?

Mr Liddell: It is possible to imagine a scenario in which they could not but that would need to not just be a small country, it would have to be an inappropriately managed clearing house that was undersupervised and faced some very adverse market conditions. Under those circumstances then, of course, yes, it is possible.

Q136 Lord Jordan: Should they be supervised at national level?

Mr Liddell: Definitely. The question then is what in addition to that national supervisory regime should they be subjected to, and again, my view is that there needs to be as a minimum a lot of co-ordination and co-operation between that national regulator and other global important financial regulators, particularly in major currencies.

Q137 Chairman: Do you think a CCP should have access to central bank liquidity in extremis?

Mr Liddell: I think there are two possible reasons why a CCP may wish to have central bank money. One is to improve potentially the certainty of its day-to-day operations, certainty as it pertains to immediate intraday finality of payments which is best achieved by a direct account at central banks. The other reason why it may need access to central bank money could be as a means of providing some backstop liquidity in the event of a real crisis. The two are really quite different. So the answer to the first would be definitely yes, because it makes the system more robust; the answer to the second is there are some situations where temporary liquidity could be beneficial. Again, each of the clearing houses really is designing their business model to prevent the need for that, but in the event that it was necessary then it would be a sensible measure to take. I am very nervous, however, about the sort of moral hazard associated with explicit guarantees to organisations like ours. I really believe that in principle we should not feel we have any guarantee from anybody at all, and should be operating on that basis.

Q138 Chairman: So no lender of last resort with the CCPs?

Mr Liddell: I am not saying no lender of last resort; I am just offering a personal opinion which is that I can see why a lot of people feel that having a facility which is effectively an underwritten guarantee is a good thing. My personal view is that it is somewhat inappropriate and I think there needs to be a willingness and an appetite to make decisions by central banks, regulators and market infrastructure in the event of some severe circumstances which are not necessarily all laid down.

Q139 Baroness Northover: I am glad you added that second point because clearly a lot of people would be very concerned if that were the case. As you have just said, you want to be assessing the risk yourselves and not necessarily be bailed out. Is that how you would summarise the position?

Mr Liddell: Yes. We should be designing our business on the assumption we have no access to anything at all other than what we have under our control, and if that does not work we have failed.

Q140 Baroness Northover: So you do not think that should be built in in any way to the regulations?

Mr Liddell: I would fall short of arguing explicitly against it but, again, my personal orientation is to feel it is not the right way to set these things up. I am not sure there are that many that would agree with me, though. It may be a little old-fashioned!

Q141 Chairman: Mr Liddell and Mr Cunningham, you have been, as with all witnesses, extremely generous with your time and, I have to say, articulate

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and to the point, and we are very grateful for that. Is there anything you think we have missed that we should have in mind when we come to write our brief report on this occasion?

Mr Liddell: No, but perhaps I could make one brief concluding remark in terms of the testimony I have given and the previous participants. There may

sound like there are some inconsistencies; in fact, there are not. The answers differ depending on which segment of the market you are referring to, so if there are any specific concerns you have over what might appear to be differences I would be happy to try and help clarify them subsequently.

Chairman: You are very kind. Thank you again for coming.

Supplementary memorandum by LCH.Clearnet

This note has been prepared in response to the Committee's request for clarification of Mr Liddell's comments about issues experience in handling the Lehman insolvency related to clients' positions and assets. These were described in the FSA's March 2009 Discussion Paper DP09/2, "A regulatory response to the global banking crisis"⁸ and also in the Treasury's May 2009 consultative report "Developing effective resolution arrangements for investment banks":⁹

- 2.47 CCPs interpose themselves between the buy and sell sides of each trade that is 'cleared' and act to guarantee the performance of the trade by becoming the counterparty to the original parties to the trade.
- 2.48 The FSA is reviewing the arrangements for the holding of both client positions and margins at the clearing house level. This review has been prompted particularly by the Lehman Brothers' default where client positions were held in a house account (which generally allows some economising on margin, as positions can be netted across client and house business). That situation has raised questions as to the level of understanding by clients of the effects of account segregation and the appropriateness of current clearing account arrangements.

The main issue, as Mr Liddell stated, is that when the amount of collateral held by the CCP is calculated on a netted basis across a number of individual clients' positions, it may prove difficult to disentangle a specific client's collateral and transfer it, together with the related contractual obligations, to another (solvent) clearing member. In our response to the Treasury's paper,¹⁰ we commented inter alia that:

"Presently, many clearing members hold client positions in an omnibus client account for which initial margin is collected on a net basis. As the positions in an omnibus account have natural offsets between each other, in the event of the default of the clearing member, the transfer of client positions to more than one replacement clearing member may not be possible since it will potentially unbalance the omnibus account and cause a shortfall of initial margin. As a result, consideration needs to be given to an equitable method to transfer client positions, possibly by giving a clearing house the power to transfer the entire omnibus account (and its corresponding initial margin and clients) to another clearing member. Those clients who do not wish to transfer would have the option of closing out their positions with the replacement clearing member once those positions have been transferred."

We are however confident that the continuing consultative process will lead to a more satisfactory structure. Meanwhile we are already developing our OTC clearing services in order to offer more comprehensive segregation facilities to support the client clearing service that Mr. Liddell referred to in a later answer.

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⁸ http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf

⁹ http://www.hm-treasury.gov.uk/d/consult_investmentbank110509.pdf; followed in December 2009 by the ongoing consultation "Establishing resolution arrangements for investment banks" http://www.hm-treasury.gov.uk/d/consult_investmentbank161209.pdf

¹⁰ http://www.hm-treasury.gov.uk/d/lch_clearnet_10jul09.pdf

Written Evidence

Memorandum by Argus Media Limited

1. BACKGROUND TO THE ARGUS SUBMISSION

1.1 Argus Media Limited (“Argus”) is the only independently owned global energy market price reporting and market intelligence service. Argus is a UK limited company owned entirely by its employees and the family of the founder. It has twice won the Queen’s Award for Enterprise, most recently in 2009.

1.2 Argus produces daily price benchmarks for the spot physical energy markets. On a daily basis Argus polls market participants in a wide range of physical energy markets, producing expert assessments of the prevailing spot market price based on the output of these surveys. These benchmarks are widely used within the industry where an independent spot market price assessment is required. For example, HM Revenue and Customs uses Argus North Sea crude oil benchmarks as a price reference for taxation. Argus price benchmarks are extensively used by the energy industry in their contracts for physical energy supplies. Argus price assessments are also widely used for the settlement of energy derivative contracts.

1.3 The generation of reliable energy price benchmarks is a full-time enterprise that is already provided by price reporting agencies (PRAs). Argus believes that the European Commission would be well served by satisfying itself that the PRAs such as Argus are well placed to provide this function. Argus would be willing to enter a deeper dialogue with the Commission to help explain our price assessment processes, including the rigorous safeguards in place to ensure the integrity of the assessments.

1.4 Argus supports the aims of the Commission in increasing the robustness of the derivatives market, but notes energy derivatives are inherently more robust than financial derivatives. Energy derivatives are used for vital commercial risk management functions by businesses with an energy price exposure. They are underpinned by the physical asset or commodity, and therefore do not represent anything like the same degree of systemic risk as purely financially based derivatives. In addition, energy derivatives markets are much smaller than the markets in financial derivatives, both in aggregate and as individual products.

1.5 As Argus is a service provider specifically for the energy markets, this response addresses only energy derivatives. It does not concern other financial derivatives such as credit default swaps, foreign exchange or interest rate swaps. Argus is both an independent observer of energy markets as well as a service provider to them and our response reflects these two roles.

1.6 Strictly speaking, the term “derivatives” covers both regulated exchange-traded futures and options markets, as well as unregulated markets that are either traded bilaterally (“over the counter” or OTC) or cleared via a central counterparty (CCP). The European Commission proposals are purely concerned with the latter category, as is this response.

2. DERIVATIVES

What economic benefits do derivatives bring?

2.1 OTC energy derivatives are important, because they can be tailored to specific requirements and so allow businesses to manage their exposure to energy prices much more effectively than by purely using regulated futures markets. OTC energy derivatives help generate increased liquidity in exchange-traded energy derivatives, which further improves the efficient transfer of risk.

What risks are associated with derivatives and derivatives markets?

2.2 OTC derivative contracts exhibit two important risks that need to be mitigated. Firstly, there is the risk of counterparty default. This is managed by two means in derivative markets. Either the two counterparties in a transaction are mutually satisfied by their respective counterparty risk and enter a bilateral transaction (the bilateral agreement may impose counterparty risk reduction obligations on one party such as the requirement to post a bank letter of credit). Or if they are not satisfied, they may choose to use a clearing service provided by a clearing house or CCP. Secondly, there is the risk of a misleading or false underlying asset valuation, leading to mistrust in the financial instrument itself and potentially to a financial settlement that exceeds the boundaries initially set by the counterparties.

What role did derivatives play in the recent financial crisis?

2.3 Argus is not a commentator on financial markets, and can add little in terms of specialist knowledge on how financial derivatives affected the recent financial crisis. However, Argus strongly believes that energy derivatives did not play a role in the systemic breakdown of financial markets. In fact, throughout the financial crisis the energy markets continued to perform a highly effective role in providing a price balancing mechanism for global supply and demand.

2.4 It is argued by some that excessive speculation caused the price spike that occurred in the energy markets in mid-2008. Argus does not support this view, which ignores the facts that the world was then at the peak of a period of unprecedented economic growth and that during this growth phase there was a fundamental shortage of high quality energy products to drive the economic growth. A number of authoritative studies of trade data from futures markets have shown that during this price spike, so-called speculators such as fund managers were reducing their net energy futures positions.¹

3. CLEARING DIRECTIVE

What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?

3.1 Argus is one of a number of PRAs that compete in the provision of robust, reliable, independent price benchmarks of the physical energy markets that are used for settlement of various energy derivatives. It is important to ensure that the financial settlement of OTC derivatives is set on firm foundations. The Commission may wish to consider requiring CCPs to use only independent benchmarks, to minimise the risk of any misleading valuation of the underlying asset.

Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?

3.2 This question assumes that “standard derivatives” has a universally applicable meaning. It does not, and the meaning could vary by market or legal jurisdiction. This in turn carries a danger of regulatory arbitrage, through inconsistent definition and application of what is standard and what is not.

3.3 Any proposal to mandate clearing of OTC energy derivatives should recognise that clearing houses already innovate and compete to provide clearing services for a wide range of specialised energy derivatives. Argus is not aware of any instances of an OTC energy derivative market counterparty seeking to obtain a clearing service and being unable to do so. Mandated clearing carries with it the risks, firstly of higher cost in the provision of clearing services—costs that would ultimately be borne by the consumer—and secondly of the CCP taking on board types of clearing risk that it would be unable to effectively manage. Argus therefore believes that it is preferable to facilitate the existing dynamics of market innovation that are providing the required risk mitigation services, such as voluntary CCP clearing.

3.4 We make no comment directly on MiFID and in particular how this should be modified if the Commission concludes that central clearing should be mandated.

4. TRADE REPOSITORY DIRECTIVE

What benefits do the use of trade repositories bring both in terms of transparency and improved risk management?

4.1 Trade repositories would benefit the Commission by bringing increased transparency on counterparty risk and positions in OTC derivatives markets. However, the Commission should underestimate neither the extremely high degree of complexity in the derivative markets and therefore the complexity of the trade repository, nor the challenge of interpreting the raw trade data.

4.2 Should the Commission require PRAs such as Argus to provide its own price benchmark updates into the trade repository for the purposes of position valuation or mark-to-market, Argus would be willing to do so, on the assumption that the repository is intended purely for regulatory purposes and not for public consumption. Argus respectfully requests that such settlement information on market prices and trade only be made public on a time-lagged and aggregated basis, if at all. This is in order to protect the viability of the commercial service already provided by PRAs including Argus.

¹ The most comprehensive of these studies is by the US Commodities and Futures Trading Commission, which regulates futures exchanges in the USA, published in December 2008: <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/marketreportenergyfutures.pdf>. Also, see *Global Commodities: a long term vision for stable, secure and sustainable global markets* HM Treasury, (June 2008) at p. 25. <http://www.hm-treasury.gov.uk/d/globalcommodities.pdf>. These and other studies are summarised in one IOSCO report: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD285.pdf>.

5. FURTHER ISSUES

Are current EU regulatory plans regarding derivative markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?

5.1 The Commission should take care to recognise where there are exemptions to regulation in the US that may not exist in Europe. For example, in the US, a significant volume of energy market price risk management takes place on markets known as “physical forwards”. These are essentially OTC derivative markets that are settled by physical delivery of the underlying commodity, rather than by financial settlement. These physical forwards contracts are explicitly exempted from the draft US legislation on OTC derivatives. However, a similar market exemption does not exist in Europe. This means that EU regulation may be stricter than in the US, potentially causing either higher risk-management costs in Europe and/or a migration of business to the US markets.

29 January 2010

Memorandum by Ashurst LLP

SUMMARY

- Derivatives are risk management tools, but by focusing on derivatives the Commission’s communications are prioritising legal form over economic substance.
- Centrally clearing dealings between financial institutions will alter the legal nature of the relationship between the institutions fundamentally. It will increase certainty of contract and disapply insolvency stays.
- Central clearing of client contracts will not substantially alter the legal nature of the relationship between the client and the financial institution it uses, although it will alter the nature of most collateral arrangements and for that reason is likely to introduce additional operational risk.
- Introducing penalties for non-standardised/centrally cleared derivatives will not prevent some derivatives from needing to be bespoke and/or bilaterally cleared. It will result in greater regulatory arbitrage.
- Trade repositories should be private not public law bodies.
- Increased use of collateral can mitigate credit risk but will introduce other risks. The benefits of increased collateral are much greater for transactions between financial institutions than for transactions with end users.

What economic benefits do derivatives bring?

The focus in the Commission’s communications on derivative transactions is a focus on form over substance. A derivative transaction allows the parties to allocate an identified risk to the party best placed to manage that risk. OTC derivatives are usually an efficient way to achieve this, but similar economic results can be achieved in a number of other ways. There are many other forms of contract that do the same thing: insurance, guarantees, letters of credit, factoring, repos, spread betting, North Sea take or pay contracts, and even retail contracts such as term-based fixed price gas supply contracts. Alternatively such exposures may be a natural consequence of other economic activity—which in the past derivatives have been used to hedge—but which could be used to create or transfer the exposure if desired.

It is important to distinguish between risks (such as counterparty risk, i.e. the risk of non-performance by a party to a derivative transaction) that are attributable to the derivative transaction itself and the underlying economic exposures (such as interest rates, share prices, or other volatile and fungible risks) which the derivative transaction allocates between the parties and to which it relates. These economic exposures will continue to exist whatever rules or regulations are introduced in relation to derivatives. Derivatives are simply one tool (of several) to help manage them. The benefit of derivatives, and the reason they raise concerns as an asset class, is that they are such an efficient tool.

Derivatives are also, in legal terms, contractual obligations and so, all other things being equal, parties entering into derivative transactions should benefit from general contractual freedoms. Freedom of contract is a principle of English contract law and this principle is important economically. In fact derivatives do raise concerns and so freedom of contract is already restricted: one of the parties to a derivative transaction in the UK must usually be a regulated financial institution. However, given rules on the construction of contracts, any further specific restrictions on derivative transactions will need to articulate a clear policy about the reason and extent of the restrictions.

What risks are associated with derivatives and derivatives markets?

For financial institutions, the legal risks associated with over-the-counter (“OTC”) derivatives and exchange traded derivatives are quite different. By contrast, the relationship between a financial institution and its client creates many similar legal risks whether OTC or exchange-traded derivatives are involved. Any non-financial institution will not have direct access to the exchange and so will still need to use a financial institution to enter into transactions. To date, the main use of central counterparties (a “CCP”) has been for exchange-traded derivatives. It seems likely that a CCP for OTC markets will adopt an approach similar to the exchange-traded markets (as Swapclear, a service of LCH.Cleamnet has done).

There is no “market” for OTC derivatives in a legal sense. There is simply a complex network of bilateral (and sometimes multilateral) contracts. The risks associated with OTC derivatives are therefore the usual risks associated with non-performance of contractual obligations. This may be a result of the insolvency of one of the parties, so that it is unable to perform any of its unsecured contractual obligations in full, or it may be due to the unenforceability of the particular contract. Reasons for unenforceability of a derivative transaction may include mistake, a lack of capacity (such as with UK local authorities) or a lack of due authorisation, a breach of a duty of care by a trustee, a failure to comply with the Financial Services and Markets Act 2000 (if required), recharacterisation of the contract by the courts (eg. as an unenforceable gaming or insurance contract), a failure to establish sufficient “control” of financial collateral, or a failure to attach and perfect a security interest in other security assets, and in the case of netting arrangements a lack of mutuality between the obligations of the different parties.

In many cases these “risks” operate to protect a weaker party. Financial-institutions dedicate significant resources into checking issues such as capacity and authority for potential counterparties, and in legal due diligence on transaction documentation and contractual arrangements to ensure that they do not end up with contracts that they cannot properly enforce against their clients.

One final risk is the risk of frustration. OTC derivatives tend to make express provision for this, so that (so far as possible) the economic value of the contract is still owed by the relevant party to the other, even if performance of the specific obligation is impossible. Exchange-traded derivatives take a similar approach.

Unlike OTC, exchange-traded derivatives are defined by statute. The Companies Act 1985 Part VII defines “market contracts” and FSMA 2000 defines a “recognised investment exchange” and a “recognised clearing house”. The effect of this legislation (CA Part VII in particular) is to give precedence to the rules of an exchange and the relevant CCP over other law, including insolvency legislation. The rules will normally divide market participants into clearing members, dealing members and clients. Financial institutions will be clearing members (with rights to trade with a CCP) or dealing members (with more limited rights). Clients will not have direct access to the exchange and their rights and obligations will largely depend on contractual arrangements agreed with a financial institution.

One purpose of most market rules is to remove the risks associated with bilateral contracts so that they do not apply to contracts traded on the exchange (and with a CCP). The best example of this (although not English law) is the unauthorised actions of Nick Leeson dealing on the Singapore International Monetary Exchange and the resultant bankruptcy of Barings Plc: the rules of SIMEX required performance of the contracts. For financial institutions dealing with each other this reduces their risk. Clients also benefit from this certainty of contract—although any solvent financial firm would honour commitments for reputational reasons. It will not protect a financial institution dealing with clients. A financial institution dealing with a CCP on behalf of a client will still legally be responsible for the client relationship. It will be required to honour transactions with the CCP but may not be able to pass this on to a client who lacks capacity or authority to trade.

A second purpose of market rules is the mutualisation of risk. A CCP relies on financial resource and margining requirements to protect itself in its dealing with members of the exchange. The CCP will also establish its own funds and additional stand-by funding commitments, usually as part of the price of membership of the exchange. The CCP insulates market participants from risk on the insolvency of any other individual market participant. A CCP contracts on a back-to-back basis with the economic principals on any transaction (isolating each from any direct risk on the other). The CCP will only deal with clearing members, which will be pre-vetted and have to meet financial resources requirements, and any members allowed to deal but not clear (dealing members) will need to novate their transactions to a clearing member as part of the daily settlement mechanics. However, although difficult to quantify (or disclose), standby commitments create “fat-tail” credit risk for members—the last ones standing footing the bill as others default. One solution would be for there to be a state-sponsored funder of last resort: but (formally at least) this is not the case at the moment.

CCP rules will also require “compression” of positions by netting any equal and opposite contracts at the end of each trading day. Market participants must post collateral to provide a basic cushion and to cover a percentage of their overall net liabilities, adjusted daily. Unlike OTC markets everyone gives the CCP

collateral (even if the CCP is net out-of-the-money ie would need to pay up to terminate the transactions) but quite often only a proportion (rather than the full amount) of the prevailing exposure is collateralised. The CCP does not charge for this credit risk but has a unilateral power to raise the proportion of net exposure collateralised or to close out positions. A client will need to agree arrangements with a clearing member (and dealing members, if desired) to comply with these requirements. Again, the financial institution will be at risk for any mismatch between its obligations to the CCP and the enforceability of terms that it is able to impose on its clients contractually—although many rules impose a minimum collateral requirement for the client agreement equal to the amount the CCP requires from time to time.

A final purpose of most market rules is to allow client collateral and client positions to be managed separately from those of a financial institution should the financial institution default, or from other clients should a client default. This will be achieved in the UK by a statutory trust under Chapter 7 of the Client Assets Sourcebook issued by the Financial Services Authority (CASS 7). Contractual provisions between the financial institution and its clients will also reinforce this. When implemented effectively, these provisions allow client positions to continue without acceleration (which would crystallise a mark-to-market loss or gain for the client and remove the exposure to market risk originally needed as a hedge or investment) and to be novated to a new clearing member without ever becoming part of the insolvent estate of the defaulting financial institution. However segregation by client is expensive, and many clients prefer a degree of co-mingling. Segregation also creates significant operational risk for clients and the financial institution. If a financial institution doesn't segregate (when it should have done so) clients will instead only have rights to trace or unsecured claims to compensation. These issues are discussed at length by Briggs J in his judgement of 15 December 2009 in relation to the "Client Money Application" and *In re Lehman Brothers International (Europe)* (in administration). An equivalent risk does not exist in OTC markets since collateral is based on title transfer netting arrangements. Again it is difficult for a going concern to quantify or disclose this operational risk, so it will be largely undisclosed.

What role did derivatives play in the recent financial crisis?

No comment.

Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?

A CCP will only ever itself deal with a small, identified group of financial institutions and will require those financial institutions to enter into back-to-back transactions with their clients. If regulated at EU level these back-to-back transactions would require uniform laws across civil and common law jurisdictions in relation to equitable interests in private property and bilateral contractual arrangements, as well as related choice of law rules. This will be difficult to achieve in practice. For that reason also, national authorities may also be best placed to regulate CCPs.

National supervision of CCPs is already subject to harmonisation, principally under the Markets in Financial Instruments Directive (2004/39/EC). A further Directive may be useful to change the details of the current rules if required. More significant changes, particularly a change to EU supervision, may be better implemented by Regulation or treaty amendments.

What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?

Any legislation must give precedence to CCP rules so far as dealings with the CCP are concerned (including in relation to insolvency laws). Legislation should also ensure segregation of client margin is enforceable.

Reforms are needed for EU-wide certainty in relation to back-to-back contractual arrangements between financial institutions and their clients. In particular terminating and netting arrangements with clients on their default, and the perfection and enforceability of client collateral (and rights to use client collateral for on-posting to the CCP) need to apply on an EU-wide basis. Reforms should also permit netting and application of collateral across both centrally cleared and bilaterally cleared contracts.

Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?

The concept of a "standard derivative" is difficult to define. Derivatives allow risks to be aggregated or isolated in unique ways. As a result, if there were an economic incentive to do so, it would be relatively easy to make each transaction bespoke. If central clearing were made mandatory for standard derivatives it would require co-operation from financial institutions to make derivatives conform to standard. However mandatory rules are not the only incentive. Financial institutions benefit from standardisation, since this creates liquidity and

lowers execution costs, particularly legal costs. CCPs will be successful, and will grow market share, provided that execution costs are low and provided that CCP can offer sufficient liquidity in any given product.

Although coercion may be one way to achieve liquidity, it could also be provided in other ways. The downside of mandatory clearing is that it will create uncertainty (and an industry for lawyers giving opinions) for any other contractual arrangements which could be recharacterised as a “standard derivative”. Given the extensive overlap of derivatives with other risk management tools this could be a significant burden for certain industries. In the end the concern may turn out to be how to stop financial institutions using CCPs for non-standard contracts (and so passing on unmanageable risks to the CCPs).

MiFID is already complex and may not be the best tool to achieve EU-wide reform. Although a useful starting point, the definition of investment services and activities used in MiFID, and the exemptions, will differ from the needs of any regime on mandatory clearing. This is because legislation on mandatory clearing should focus on capturing pools of liquidity and not on being as comprehensive as possible.

Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?

Financial institutions impose counterparty-specific credit charges on OTC derivatives with clients. They also make their own calculations for collateral requirements with OTC clients. At the moment clients do not pay credit charges for transactions executed on their behalf with CCPs, and differences in creditworthiness can only be reflected by different collateralisation requirements and varying exposure limits. The approach to client credit risk management is therefore quite different. However it is not clear that one is better than the other across all circumstances.

Making OTC derivatives less efficient will not alter the economic needs of derivative counterparties. However counterparties will instead investigate which is the most efficient contractual regime to achieve their objectives. This may be purely financial or it may be driven by other considerations as well: for example most standardised derivatives will not be hedge effective under IAS 39. Although the Commission is concerned to prevent regulatory arbitrage, higher capital charges are likely to exacerbate it.

In some cases derivatives are simply unsuitable for central clearing or standardisation. This is particularly the case for structured finance business. Rating agency requirements for a bankruptcy remote SPV (for example a securitisation issuer) or a covered bond issuer require a swap provider to rank *pari passu* or even (in some circumstances) below investors. They may also require a swap provider to post collateral, rather than receive it. A CCP cannot agree to this. If such hedging transactions were to be centrally cleared the CCP would require super-priority. In the case of covered bond issuers, national laws relating to the segregation of cover pools would need to change. Equally such transactions are not eligible for standardisation. Rating agencies require the SPV's obligations under a swap to be no more extensive than the cashflow from its investments. If higher capital charges are applied to such transactions (and/or if financial institutions end-up warehousing any basis risk or funding costs as between the CCP and the SPV), ultimately the costs of this will be borne by investors. This will affect investment returns.

What benefits the use of trade repositories bring both in terms of transparency and improved risk management?

No comment.

Should the EU regulate the legal framework for the operation of trade repositories?

Registration requirements exist in various jurisdictions for a variety of transactions, particularly the creation of security, interests in listed shares, assignments of contractual rights and interests in mobile equipment. Usually the main benefit is the publication, or deemed publication (for various legal purposes) of the information registered. This is not the intention in this case. In fact publication may expose financial institutions to liability for breach of confidentiality requirements and/or may disrupt prices.

Transactions registered in a trade repository will represent property rights. Those property rights will be able to be terminated, set-off, given as security or novated outside the trade repository. The trade repository may need to amend records to reflect this (and whether this will be necessary is an important policy question). However, in order to avoid a need for dual registration of (for example) a security interest, the records of a trade repository should be used for financial institution reporting purposes only and have no bearing on the enforceability or interpretation of any registered transaction, or any subsequent dealings in that transaction. A trade repository should therefore be a private enterprise and should only be regulated like one.

In the UK a Bank's own records are prima facie evidence of their contents under the Banker's Books Evidence Act 1879. Rules will be needed to determine the extent to which records at a trade repository are admissible (and/or compellable) evidence. Preferably this presumption should be disapplied for the records of a trade repository.

What provisions and rules should such regulation impose to improve regulation of trade repositories?

Not applicable.

Should trade repositories be supervised by ESMA or by national supervisory authorities?

No comment.

Will extending the Market Abuse Directive to capture more OTC derivatives and giving regulators the power to set position limits improve the integrity of derivative markets?

No comment.

Will increased collateral levels in bilaterally cleared products increase stability?

The Commission intends to set minimum levels of initial and variation margin (using cash or securities, ie financial collateral) for OTC derivatives. Financial collateral does not remove risk. Instead it changes counterparty credit risk into market risk on the collateral, legal risk, operational risk and liquidity risk. Although markets are not always efficient, counterparty credit risk and risk on the collateral can be quantified and priced. It is less easy to measure and manage these other risks, although they can be significant.

Corporates do not usually have the systems in place to be able to operate financial collateral requirements efficiently. They also have limited access to new sources of liquidity. A CCP will increase collateral requirements as a credit deteriorates. If this affects strategic hedging transactions, it will be difficult for a corporate to manage. In fact where liquidity triggers are credit related this can create systemic risk. Banque AIG SA had entered into collateral arrangements with a number of its OTC derivative counterparties. These agreements required little or no collateral at the date of signature, but subsequently required significant amounts. AIG was unable to fund the collateral requirements when they increased due to a downgrade in its credit ratings.

Corporate users of derivative transactions prefer to give a charge over their operating assets to a derivative bank, rather than give or receive financial collateral. The security is usually created in favour of a syndicate of banks as part of the corporate's general funding arrangements; the derivative, any funding (and all of the banks) ranking pari passu. A key object of the documentation is to ensure that no individual bank is able to enforce the security—or to accelerate claims—independently of the other banks. This is to ensure that, if necessary, any restructuring of the corporate's debts is binding on all creditors. Introducing minimum variation margin requirements for derivatives will have the opposite effect. It will allow the derivative bank to get out ahead of other creditors.

Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?

Although greater harmonisation between jurisdictions is desirable, mandatory central clearing for derivatives will not promote this. In fact CCPs make universal regulation more difficult because CCP rules need to resolve any conflicts of law issues in favour of the CCP.

More generally, the financial crisis has seen a policy shift towards ring-fencing local assets in favour of local creditors. This is the effect of the Special Resolution Regime in the Banking Act 2009 and similar proposals overseas. It is best illustrated by the asset freezing orders made in relation to the Icelandic Banks—which were a precursor of reform of bank insolvency in the UK.

Are there further areas for regulation that the communications do not cover?

No comment.

1 February 2010

Memorandum by The Association of Corporate Treasurers (ACT)

1. The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided on our website www.treasurers.org.
2. We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine* and our Policy and Technical Committee. The evidence herein is submitted by the ACT as author acting as a professional body taking the point of view of the non financial companies who use derivatives.

SUMMARY

3. The ACT accepts that there are certain features of derivatives that can generate substantial contingent credit exposures between major market participants. In the event of the failure of a significant market participant there could be a threat to the stability of financial systems. However that risk arises within the activities of financial firms. Non financial companies and their activities in the derivative markets are very unlikely to create any systemic risk.
4. Non financial companies generally do not use some of the more risky credit derivatives and the derivatives that they do use are for hedging purposes. The ACT is strongly of the view that any requirements for mandatory margining should not apply to non financial companies. This is partly because such companies pose no material risk. But most importantly because any such requirement would introduce new and significant cash flow risks during the life of the contract—a contract used to protect cash flow on ultimate maturity when matching the underlying business risk. This would be damaging to individual companies and the wider economy as companies responded to the new risk.
5. Attachments:
Letter from the EACT to the European Union Commissioners dated 6th January 2010
A summary position paper from the European Association of Corporate Treasurers—September 2009

GENERAL

6. The ACT accepts that derivatives can be inherently highly leveraged so that as markets move very large exposures can build up and these exposures are not particularly visible to the market and analysts. By its nature, derivative trading can be carried out with no initial payments between the parties. Then as market prices move one party can become “out of the money” and effectively owe money to the other party. Were a major, systemically significant firm to fail or get into financial difficulties there could be a loss of confidence spread rapidly through the market because of the large and interconnected, but invisible counterparty credit exposures. There could be concern about excessive risk between financial counterparties that could pose a risk to financial stability.
7. It is therefore reasonable for the European Commission to be considering proposals to help reduce this potential for systemic risk. The systemic risk arises from the network of interconnections between financial firms and the large positions they build up.
8. For non financial companies the positions in derivatives are much smaller and less concentrated so that any failures in such companies are unlikely to create a threat to the financial system as a whole or even to the derivatives markets themselves. BIS semiannual OTC derivatives statistics at end-June 2009 show that in the OTC FX derivatives markets, for instance, non financials (companies and governments) accounted for 17% of outstanding notional amounts and 21% of outstanding gross market values.²
9. The ACT has considered the proposals from the point of view of the non financial companies who use derivatives. There has been a very significant and widespread concern from these companies that the proposals could, whether intentionally or unintentionally, make the use of derivatives difficult or totally impractical. The ACT does not want to stand in the way of improvements to streamline OTC processes and reduce overall risk, but at the same time we do not want to see convenient and flexible hedging instruments made inaccessible for non-financial sector companies.

The danger is that, in attempting to reduce systemic risk, ordinary companies are put off using derivatives and therefore end up with more commercial risks unhedged or hedged by more inconvenient or expensive means and so negatively affecting the wider business and economy. Alternatively they continue to use derivatives and although counterparty credit risk is minimised through margining and use of a Central Clearing Counter Party (CCP) whereby those end users are exposed to a funding and liquidity risk during contract life which again could negatively affect the wider business and economy. This would be counterproductive, as it would decrease

² Bank for International Settlements—Semiannual OTC derivatives statistics at end-June 2009: <http://www.bis.org/statistics/otcder/dt1920a.pdf>

counterparty credit risk, but actually increase overall credit risk in the system due to the associated cash flow volatility.

10. Conceptually the idea of moving all bilateral credit exposures so that a CCP is interposed between the parties does allow for collateral security to be put in place and for extensive netting of exposures. For the parties to the transaction and for the system as a whole this may be beneficial. However there can be circumstances, particularly if there are multiple CCPs when it may add to overall margin requirements and counterparty risk.³

11. The proposals requiring mandatory collateralisation of contracts, either bilaterally or via a CCP, if applied to non financial companies, would be the part of the proposals of most concern to companies. Non-financial companies mostly use derivatives for hedging—the objective being to remove variability from some future business cash flow—so that:

- movement in *value* of the derivative over its life compensates for the opposite movement in *value* of the future business cash flow; and
- the *cash flow* associated with the derivative on maturity is available to match the (opposite) *cash flow* on the underlying business cash flow.

12. If, however, the derivative is subject to daily cash margining, a totally new cash flow volatility is introduced during the life of the derivative. From that point of view the company is in some ways in a worse position than were it not to hedge: it has to keep liquidity available every day for any size of movement in required margin and there is no matching of these potential daily cash flows with the underlying business cash flow.

13. Any cash requirements for margin calls will have to come from cash or from borrowing facilities or from new bond issues or equity issues. For some companies this can be problematic. Even where new borrowing facilities can be arranged it would be using up valuable borrowing capacity in an unproductive way with knock on effects on economic activity. Furthermore many existing company borrowing agreements include a negative pledge which precludes the giving of security to any creditor. Providing margin would come within this and be forbidden, in which case existing lenders will have to be approached to negotiate an exception to this clause, which would not necessarily be granted or might entail payment of an additional fee.

14. A non-financial company's derivative position is directly related to its underlying business exposures and so the outstandings are limited by that. Financial institutions (defined widely), however, are more highly geared and can take proprietary, speculative, positions limited only by prudence and regulatory capital requirements.

15. Of course the variation in value of the derivative during its life can put the user company “in the money”—with a contingent receivable from the counterparty (bank). The size of this can represent a significant sum for the company. With the company's small, concentrated and undiversified credit portfolio, the sum can exceed the amount the company is happy with having outstanding from the bank. Companies can ask the bank for margin in such cases. And, of course if a bank is unhappy about a contingent sum due from the company it can ask for margin too (though banks with their large, diversified credit portfolios usually mark a much larger limit for companies than the companies can mark for the bank). And, to ease administration in such cases, margin may be recalculated only every so often (fortnightly, monthly, etc.) and be paid only when above a materiality threshold. Some companies, for some trades, will use exchange traded contracts where daily margining and central clearing is a requirement where they feel able to manage the attendant cash flow risks—but this is only a small minority of companies and even then usually for only part of their activity.

16. The ACT has concluded that while there may be merits in introducing more extensive use of CCPs for financial parties dealing between themselves. However, making it mandatory in dealings with non-financials would be damaging for them (and the wider economy) and unnecessary, since non-financials are not likely to pose a significant risk to the stability of the financial system.

17. The extent of concern across Europe over the current OTC derivative proposals was reflected in the number and range of companies that were keen to add their names to a letter from the European Association of Corporate Treasurers to the European Union Commissioners.⁴ Over 160 companies have publically put their name to this letter as did the ACT and other National Treasury Associations across Europe. It is appended to this response.

18. On behalf of the Treasury Associations in Europe the EACT has issued a position paper on the EU proposals for OTC derivatives and this is fully endorsed by the ACT. It is appended to this response.⁵

Particular questions:

³ The conditions under which a CCP may reduce counterparty risk or increase it are discussed in *Does a Central Clearing Counterparty Reduce Counterparty Risk*, Darrell Duffie and Haoxiang Zhu, Stanford University, July 2009, <http://www.stanford.edu/~duffie/DuffieZhu.pdf>

⁴ Available at <http://www.treasurers.org/otcderivatives/eactresponse/201001>

⁵ Available at <http://www.treasurers.org/otcderivatives/euproposals/eactresponse>

DERIVATIVES

What economic benefits do derivatives bring?

19. Derivatives do offer a convenient mechanism whereby certain risks can be transferred to the parties best able to bear those risks or to manage them to the mutual benefit of the parties and to the economy as a whole. In a simplified example a sterling based company with a business exposure to the receipt of \$ can sell its \$ forward to a bank to achieve certainty. The bank can lay off its risk by selling those \$ forward to another of its customers that happens to have a short position in \$ and wants to buy \$ as a hedge.

20. Non financial companies use derivatives to hedge risks that exist in their main business. They will have in place a strategy to assess those risks, both actual and forecast and to manage those risks so as to reduce volatility in the performance of the business. For example, a company exposed to foreign exchange risks in the form of sales made or contracted for, may decide to achieve complete certainty now by selling the foreign currency forward. For forecast sales it may decide on a strategy of partial hedging depending on the certainty of the forecasts. The aim is to remove some of the volatility in the value of those sales while buying the company time to adjust its cost base or take other business measures to address changes in exchange rates.

21. As a further example a company with a continuous hedging strategy—ie it hedges to a pre-determined rolling maturity on a regular basis—having to post margin in respect of out-of-the-money (OTM) hedges of forecast FX cash flows may restrict its ability to continue its hedging program at the very time when, in fact, underlying achievable rates on new and additional hedging are very attractive (hence why previous hedges are out of the money). Capacity to continue to hedge (eg due to cash flow constraints) may only become available when underlying achievable rates have deteriorated such that previous hedges require less cash collateral. The very requirement of cash collateral therefore makes the hedging process very inefficient from a cash flow and financial performance perspective. There is clear evidence that this requirement would be especially onerous for high value manufacturing/engineering firms who would have to more than double their debt capacity to accommodate new legislation. This could have profound effects for their business models.

22. Other risks where companies commonly want to hedge using derivatives include, interest rate risk, commodity price risk, including energy prices, inflation risk, property values risk and so on. A company can use outright derivative contracts (forward contracts, futures, etc.) or options (which are also derivatives).

23. A corporate could use its own balance sheet to create a form of hedge rather than using derivatives. For example, in place of a foreign exchange forward it could buy currency now and place it on deposit; in place of oil futures it could borrow cash and buy oil now and store it to cover its forecast needs; but grossing up the balance sheet is an inefficient approach which would mean proportionately more funding and equity is needed. A far better solution is to rent a part of a bank's balance sheet since they can operate with higher gearing and can benefit from the portfolio effect of aggregating counterbalancing risks.

24. There is a further reason why companies use derivatives to hedge financial exposures. That is that borrowing agreements may contain financial covenants which constrain the firm. For example then may limit debt and leases outstanding as a multiple of cash flow or interest expense (and the interest-like cost of financial leases) as a fraction of profit before interest and tax. Financial price movements which could change those ratios unfavourably (irrespective of what is happening to the underlying business) must be avoided, managed or laid off.

25. For a company, having equity is the ultimate form of risk protection buffer for those dealing with it. If a company has a risky business model it needs to hold more equity. But companies seek to use their capital in activities where they have comparative advantages and avoid those activities where they have none. That is they usually seek to lay off those risks which do not contribute an appropriate return. Some of those risks can be avoided by changing the business model. But some are unavoidable in this way if the core business is to flourish. Most companies in the real economy therefore carry and manage the operational risks of their core business but will try to shed or share other risks (such as financial price risks) via insurance and hedging and be very prudent about the risks they retain. Using derivatives to cover certain financial risks is key in this process.

What risks are associated with derivatives and derivatives markets?

26. Derivatives are a geared instrument in that for a (usually) nil initial investment large contingent gains or losses can build up during the life of the instrument. If used for speculative purposes there is a price/value risk. For a company using a derivative for hedging purposes this price risk is what they are seeking in order to match against a business risk, so that "risk" is rather a misleading term to describe it.

27. To the extent that one party to a derivative finds that its derivative value is positive there will be a contingent credit risk on the counterparty to the deal to the extent of that mark to market value. This is crystallised as a certain sum payable from one party to the other on maturity, or by each party settling its respective delivery obligations.

28. It should be noted that Bank counterparties consider the credit risk from customer derivative contracts along with the credit risk of lending to their clients. This risk is therefore firmly on the radar. In addition, the discipline that the onerous documentation and effectiveness testing requirements of International Accounting Standards (IAS 39) have brought to the corporate hedging process has significantly reduced the risk of a corporate counterparty entering into derivatives with speculative characteristics. These factors should be viewed as mitigating the credit risk associated with derivatives dealt by corporates in the normal course of business. This process has functioned successfully for decades and cannot reasonably be viewed as having contributed in any significant way to the financial crisis.

29. If the derivative has run to its maturity, there will then be a settlement risk on the settlement day in that one side to the bargain may deliver its obligation before the other party performs its side of the deal. It often is the full amount of the transaction that is exposed to default during this short time—in a forward foreign exchange deal, for example to sell US\$1 million for €700,035 (at a rate of USD1.4285 the full amounts are paid each way).

30. This settlement risk can be reduced by simultaneous payments when received by a third party (as in CLS bank in foreign exchange), or by agreeing that the only cash flow on maturity will be the net value of the flows at the price on maturity—a non deliverable forward. (So, in our example if the rate was US\$1.4 = €1, the amount to be settled is only US\$19,951—a much smaller settlement risk.

What role did derivatives play in the recent financial crisis?

31. The ACT does not have sufficient information to comment extensively on this question. However we would like to make the observation that the fear that certain financial institutions were suffering large losses on their dealings in credit derivatives did trigger wider worries and withdrawal of liquidity in several other financial markets. Before rushing to condemn all derivatives as excessively risky it is worth remembering that credit default swaps (CDS) have very different characteristics from other derivatives. Their market value will move gradually as the credit standing of the reference entity changes but will normally move very rapidly and significantly when the reference entity defaults or is near default. Most other derivatives do not normally exhibit this sudden discontinuity in value.

32. In addition, the notional value of the credit derivatives market is many times the size of the underlying asset markets. Therefore, there could be situations where the high likelihood of default (and the requirement to liquidate positions) causes a dramatic disruption in the market for the underlying assets due to short term supply/demand factors. FX and interest rate derivatives, which are the most common instruments used by non financial companies, do not exhibit this characteristic to the same extent.

33. Credit derivatives are not used at all extensively by non-financial companies.⁶

CLEARING DIRECTIVE

The Commission intends to produce legislation regulating the activities of central counterparties (CCPs) with the objective of eliminating national regulatory discrepancies, improving risk management and creating a single European market for CCPs.

Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?

What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?

Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?

Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?

34. We comment on the third and fourth bullets only.

35. Most derivative dealing is between financial sector parties. We understand that the reduction in risks in this sector is important for systemic stability. However, as discussed above, we do not think that non-financial companies represent systemic risks in the total market network. We see any mandatory requirement for margin as extremely detrimental to the operations of non-financial companies, as explained above.

⁶ They can be used to protect against credit-like exposures—not just a supplier's credit exposures but also the risk of a major supplier or joint-venturer collapsing, etc.

TRADE REPOSITORY DIRECTIVE

Central data repositories provide aggregate information of firms' positions and improve operational efficiency of Over The Counter (OTC) derivatives markets and market transparency. The communications suggest that legislation should provide a common legal framework for the operation of trade repositories. The Commission believe the European Securities and Markets Authority (ESMA) should be responsible for authorising and supervising trade repositories.

What benefits the use of trade repositories bring both in terms of transparency and improved risk management?

Should the EU regulate the legal framework for the operation of trade repositories?

What provisions and rules should such regulation impose to improve regulation of trade repositories?

Should trade repositories be supervised by ESMA or by national supervisory authorities?

36. We understand the advantages transparency can bring. On practical grounds we would expect reporting to central repositories should be by the regulated counterparty (where there is one) who would report that the counterparty is a non-reporting entity so that statistical comparability can be maintained. A simple reporting mechanism should be provided for those trades which are material and where both parties are non-regulated (if any).

37. We think it important for market confidence that the aggregate information created from the various repositories is made publicly available promptly.

FURTHER ISSUES

The Commission intends to review the Market Abuse Directive and may extend its scope to capture more OTC derivatives and give regulators the power to set position limits. Will this improve the integrity of derivatives markets as intended?

38. We see no disadvantages in subjecting derivatives generally to MAD provisions, suitably adapted.

The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?

39. As discussed above, it is necessary to separate intra-financial services trades from those with non-financial customers. As non-financial-company customers are not systemically significant, the absence of collateral in most of their OTC trades is not a concern and to require it would be to introduce great financial instability into those companies—which would not be in the interests of the wider economy.

Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?

40. It is important that the EU make sensible plans. It is preferable that the arrangements are comparable to those adopted in the US in material respects but there is no argument whatsoever for adopting changes introduced by the US which are not soundly based or are unnecessarily damaging to the real economy.

Are there further areas for regulation that the communications do not cover?

41. No comment

UNDER EMBARGO UNTIL 00.00 ON WEDNESDAY 6 JANUARY 2010

PRESS RELEASE**LEADING EUROPEAN COMPANIES UNITE AGAINST PROPOSED DERIVATIVES REGULATION**

More than 160 non-financial compares based in Europe (such as BAE Systems, Air France and Daimler) have signed a letter⁷ to the Commissioners of the European Union to urge reconsideration of the proposals being drafted to regulate the derivatives market. The letter has been prepared, by the European Association of Corporate Treasurers (EACT), which, is a grouping of 20 national associations representing treasury and finance professionals from 19 countries in Europe.

⁷ Attached as an appendix to this press release

Non-financial companies are well established as end-users of Over the Counter (OTC) derivatives to mitigate risks (such as in currencies, interest rates and commodities) arising routinely in their business. These companies were not involved in the extreme stress and systemic risk experienced in the financial sector, in response to which legislators on both sides of the Atlantic are rightly seeking to introduce a robust regulatory framework.

The EACT and end-users are concerned at the unintended consequences of the European Commission's proposals, which as published⁸ may threaten economic recovery by draining companies' liquidity into mandatory collateralisation of contracts, reducing the amount of hedging (thereby increasing business risk) and raising costs for those prudently hedging their risks.

The European Commission is evaluating its approach and preparing for an impact assessment. The EACT and end-users are encouraging consideration of how the existing, mature use of OTC derivatives can be maintained, most likely through some form of explicit recognition that the regulatory proposals are not intended to extend to non-financial companies. The EACT is committed to supporting the European Commission's efforts.

Richard Raeburn, Chairman of the European Association of Corporate Treasurers, said:

"Major non-financial companies use OTC derivatives as a safe and prudent way to manage risk. The extent of concern across Europe over the current proposals is reflected in the number and range of companies that were keen to add their names to our letter to the European Union."

"I welcome the signs that the European Commission recognises the depth of this concern and is keen to enter into a constructive dialogue with the EACT and individual companies to fully understand the issues we are highlighting".

ENSURING EFFICIENT, SAFE AND SOUND DERIVATIVES MARKETS

OPEN LETTER TO THE COMMISSIONERS OF THE EUROPEAN UNION

The undersigned companies representing all segments of Europe are supportive of the initiatives being taken in Europe and in the United States to improve transparency, accountability and stability in financial markets. However, as the regulatory framework is developed for the European Union we strongly urge you to preserve the ability of companies to manage their financial and market risk exposures by ensuring continued access to reasonably priced and customised over-the-counter (OTC) derivative products.

Non-financial companies, as end-users, use OTC derivatives to hedge the impact of movements in currencies, interest rates, commodity and other prices. This allows them to focus on their core purpose of building strong organisations, which through their growth create employment, investment and value for all stakeholders including taxpayers.

We are deeply concerned by some of the proposed reforms to the OTC derivatives market currently being considered, in that they will disadvantage many end users who rely on OTC derivatives to hedge underlying commercial exposures. Specifically, the intent to drive OTC derivative transactions into central clearing and onto exchanges will increase liquidity risk and funding costs through the requirement to post cash collateral, and reduce flexibility to match underlying commercial exposures.

Non-financial companies do not have the same ready access to liquidity that financial institutions have. This coupled with the requirement to post cash collateral based on unknown future financial market movements will place an excessive and inefficient burden on non-financial companies.

The economic effect of the requirement to provide cash collateral is to convert the primary risk for companies from that associated with counterparty exposure into liquidity risk. Non-financial companies are highly experienced in managing their counterparty risk with financial institutions; managing liquidity risk in collateral requirements is substantially more difficult for them and is less efficient.

If the proposed reforms currently being considered by the European Commission are not further refined to take account of the creation of liquidity risk throughout European business the adverse effect is likely to be twofold: a reduction in the amount of funds allocated to productive investment in the economy (as liquidity must be safeguarded to support uncertain future collateral calls); and less use of prudent hedging to eliminate market risks, with a resulting increase in uncertainty and volatility in the real economy of Europe.

We are committed to working with the European Commission to propose appropriate modifications to the proposals, in a form that does not dilute the overriding requirement (which we support) to tackle the causes of systemic risk in the operations of financial institutions. As the proposals move through the Commission and Parliament we hope that you will seek to ensure that they take proper account of the threat they pose, in their

⁸ COM(2009) 563 final, 20 October 2009—available at http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm

current form, to economic activity in Europe and to the Lisbon agenda to make the European Union the most dynamic and competitive knowledge-based economy in the world.

We look forward to working with you to promote financial system stability and transparency.

This letter is supported by the member associations of the EACT and has been signed by the following companies:

ABB	Hochtief
Ahlstrom Corporation	IMI
Air France	Imperial Tobacco Group
Aliaxis Group	Informa
AMAG Austria Metall	Irish Continental Group
Anglo American	Johnson Matthey
ArcelorMittal	K + S
Areva	Kellogg Europe Trading
Asco Industries	Kion Group
ASML	KLM Royal Dutch Airlines
Aviapartner Holding	Krka
BAE Systems	KUKA
Balfour Beatty	Kwizda Holding
Bayer	Ladbroke
Beiersdorf	Lafarge
Berlin-Chemie	Lagardere
BG Group	Liebherr-Aerospace
Bilfinger Berger	Liebherr-Emtec
British Airways	Liebherr-Werk Ehingen
British American Tobacco	Linde
British Sky Broadcasting Group	Logica
BWT	Lufthansa
Cable & Wireless	LVMH
Cadogan Estates	MAN SE
Cargolux	Marks and Spencer
Carmeuse Holding	Mediq
Celesio	Meggitt
CGS	Merck
Charter International	Miele
Claas	Mitchells & Butlers
CLT-UFA	National Grid
Cofinimmo	NATS Holdings
Consois	Nokia
Constantia Packaging	Nokia Siemens Networks
Daimler	NV Bekaert
EADS	NXP Semiconductors
EDF	ÖBB-Holding
Egger Holzwerkstoffe	OBI Group Holding
Elior	Oxea Holding
EON	Palfinger
ESB	Pearson
Etex Group	Pentland Group
Etimine	Peter Cremer Holding
Eurocash	Petrol
Experian	Porsche Holding
Faurecia	PPR
FirstGroup	Provimi
Firth Rixson	Renault
GKN	Rexam
GlaxoSmithKline	RHI
Goldrush	Robert Bosch
Greencore Group	Rolls-Royce
Greif	Royal Ahold
Grosvenor Group	Royal BAM Group

Hafele	Royal Boskalis Westminster
Hamon	Royal Cosun
Haniel	Royal Dutch Shell
Heijmans	RTL Group
Heineken	RWE
Sanofi-Aventis	The Rocco Forte Collection
SAP	The Weir Group
Sappi International	Thomas Cook Group
Schott	Tinfos Nizi
Schuitema	TNT
Scottish and Southern Energy	Trelleborg
Severn Trent	Tui Travel
Shanks Group	Umicore
SHV Holdings	United Utilities Group
Siemens	Vandemoortele
Skanska	Veba
Smith & Nephew	Verlagsgruppe Georg von Holtzbrinck
Solvay	VGP
Spectris	Vinci
Sportingbet	Volkswagen
Sun Chemical Group	VT Group
Talum	Wabco Holdings
Tech nip	Wacker Chemie
Telefonica	Wienerberger
Tele-Fonika Kable	WILO
Tesco	Wolters Kluwer
Thales	Wooninvesteringsfonds
The Capita Group	Zenitel

CORPORATE CONCERNS ABOUT OTC DERIVATIVE REGULATION

SUMMARY

The EACT's main concerns and recommendation for change are:

- It looks as though non-financial companies may be called on to put up margin monies in respect of derivative positions even though their use of those derivatives poses no systemic risk.
- Companies may be required to be able to pay margin to their contracted counterparty for negative positions during the life of a derivative although the offsetting, hedged, underlying cashflows will not take place until maturity.
- Margin calls could be large in relation to the size of companies. Capital and undrawn lines of credit must be held against potential margin for major price changes in the derivative's underlying reference.
- While margin would be received for derivatives showing a gain, it cannot be used in the business prior to maturity as it is "hot money" that could flow out again just as quickly as underlying prices change.
- All this would be likely to cause a reduction in corporate activity, with obvious consequences for the real economy, employment, taxes, etc.
- Derivative contracts between non-financial companies and the financial sector should be exempt from any requirements for mandatory margining or for use of central counterparties with margin requirements as non-financial companies pose no systemic risks in their use of derivatives.

REGULATION OF OTC DERIVATIVES

Concerns of private non-financial companies (PNFCs)

- PNFCs' major concern is that, seeking to reduce systemic risk in the financial sector, regulations will impose material cashflow risks on them. This is an unintended consequence and not an objective of the proposals. PNFCs account for a small proportion of derivative transactions and are not likely to be a systemic risk.
- Companies also see increased inconvenience and operating costs (both in the transaction prices and in administration) arising from the regulations.

How does PNFCS' cashflow risk arise from the proposed regulations?

- At present, most corporate derivative purchases are of Over The Counter (OTC) derivatives, privately negotiated with the counterparty. With no margin, cashflows normally take place on maturity, potentially matching with underlying exposures.
- If non-margined OTC derivatives are prohibited (either directly or by requiring use of central counterparties) or made expensive (by punitive capital requirements), margin cashflows can take place throughout the life of a derivative contract.
- Some companies use exchange traded or centrally cleared derivatives for some of their business, but the great majority of investment grade companies do not.

Margin (where agreed or required):

- Variation margin is, at agreed intervals, put up against any loss or received for any gain arising from the derivative contract. Initial margin (often 2% or 3% of the nominal value of the derivative) is provided as surety against daily margin payments. Variation margin can add up to much more. Exchange rate and commodity price movements of 20% or more are not uncommon—which is why companies need to hedge. Margin received can flow out again as the underlying reference price moves and can't be used in the business: it is "hot money".

Why is margin needed?

- Central counterparties for on-exchange derivatives and clearing houses have to be bankruptcy remote entities and take initial and daily margin from holders of loss making derivatives to help ensure the eventual obligations are met at maturity.
- The overwhelming majority of investment grade companies' OTC derivatives are without margin. However, parties unhappy with an OTC counterparty's credit standing may ask for collateral or margin ("credit support") when the counterparty is "out of the money". Mutual credit support is an option in standard ISDA derivative agreements. In recent years, for example, some companies have asked certain banks to give credit support for some contracts. There is no initial margin—who would pay whom? Variation margins are often only paid if above a small threshold (eg £20 million or £50 million) and recalculated weekly or fortnightly or longer to reduce administration.
- For financial companies which may be position takers with speculative portfolios which are constrained only by credit considerations, we understand that margining, including initial margin may be a useful protection of the system.

Why is margin generally not needed for non-financial companies?

- Non-financial companies use derivatives to hedge business risks. Volume is, accordingly, limited and non-financial companies account for only a small proportion of derivative outstandingsⁱ. Individually or collectively, they do not represent a systemic risk. Taking corporate credit risk is usually part of a bank's business.

What would be the consequence of requiring non-financial corporate margining?

- Increased cashflow risk from margining or alternatively not hedging identified risks would require companies to hold more risk capital and available lines of credit. Corporate activity would be reduced with obvious consequences for the real economy, employment etc.

EXPLANATORY NOTES

Hedging

- Hedging is the mitigation or elimination of a risk. It is like insurance, but insurance is used for unknowable binary risks—will your house catch fire or a ship sink, or not. Hedging is for graduated and repetitive things—frequently traded things like currencies and commodities.

Derivatives

- So called because the value of the contract is derived from some underlying price and varies with it.
- Said to be “in the money” for a party if the underlying price has moved so it could now make a gain on closing out the derivative. If closing out would be at a loss, the derivative is “out of the money” for that party.

Why do non-financial companies use derivatives

- Non-financial companies use financial derivatives for hedging risks such as interest rates, exchange rates, commodity prices, inflation and a number of others such as longevity.
- The volume of hedging is related to a firm’s business—unlike financial companies’ speculation.
- Companies usually hedge economic risks, especially cashflow risks. Some companies hedge accounting risks, but if the economic, cashflow risk not covered, or even introduced by such accounting hedging is large, this can be significantly sub-optimal.
- To the extent that companies retain exposures (ie do not hedge), they need to hold extra capital against those exposures or reduce risks elsewhere in the business, increasing cost of capital and reducing activity levels.

“Mark to market”

During the life of a derivative contract, as the market price of the underlying reference (currency, commodity, etc.) varies, the gain (“in the money”) or loss (“out of the money”) for a party to the contract from immediately terminating the contract can be estimated “marking to market”.

- “In the money” good, “out of the money” bad?
For a company, if a derivative help is “in the money”, there will have been a corresponding move in the value of the corresponding hedged item. If it represents business which will probably be repeated, while the company has the consolation of the gain on the hedged amount, it would probably have preferred that the fundamental price relationships moved in its favour rather than against it. Perhaps “out of the money” good, “in the money” bad—the opposite situation from that of a speculator.

How large are private non-financial companies in derivatives?

- Statistics from the BIS show all non-financial customers in which PNFCs are included are only a small proportion of derivative outstandings (see end note, below).

Over The Counter (OTC) Derivatives

- Agreed between the two parties, OTC derivatives can be tailor-made to suit a company’s needs. Often the legal basis is standardised (eg using standard ISDA agreements) but specifics such as amount, maturity and the underlying reference price are set out case by case.
- Are usually not margined—cashflows taking place on maturity.

Exchange traded derivatives

- Are standardised as to amounts, maturities and underlying reference prices.
- May leave some mismatch of risk for a corporate hedger (“basis risk”).
- Use central counterparties and so are margined, with initial and daily variation margins, cash flowing through the life of the derivative.

Central counterparties (CCPs)

- While on an Exchange buying and selling contracts is agreed between exchange members, the agreement is notified to the exchange’s CCP and when both sides have confirmed, the actual contracts are between the parties and the CCP. It is similarly possible for an OTC derivative for the parties to notify a CCP of their agreement and then novate the contract to the CCP, so the CCP becomes the counterparty of each.
- CCPs are used to substitute their credit standing for that of the counterparties. Accordingly they are supposed to be bankruptcy remote (unlikely to default) and have strict rules accordingly. Central counterparties have been known to default however. If there are several counterparties, they can actually increase risk by reducing the opportunities for bilateral netting.

Margin

- Because central counterparties have to be bankruptcy-remote entities and do not take credit risks, they demand “margin” monies from counterparties.
- “Initial margin”, commonly 2–3% of the nominal value of the derivative, is held as surety.
- A daily “variation margin” is required or paid by the central counterparty as the value of the derivative contract falls or rises—moves “out of” or “into the money”.
The variation margin can be very large—a 20% exchange rate movement is not unusual and commodity price variations can be larger. A company’s profit margin, which the derivative is protecting, may be only a few percent.
- Variation margin received cannot be used in the business as it could flow out again just as quickly—it is “hot money”.

Why are non-financial companies not concerned at requirements for financial companies to put up margin within the financial sector?

- Most banks have a wide variety of long and short positions they acquire from customers. They lay off most of the net residual risk with other banks, so margining overall for any institution is quite small unless it is using derivatives to take a position—speculating. So costs to customers from margining within the financial sector can be expected to be small.

Financial sector

- Used here to mean the whole financial sector, whether regulated or not.

Non-financial companies

- Companies or non-financial companies are used here to mean private non-financial companies.

BIS DATA ON OTC DERIVATIVES

BIS statistics are available at <http://www.bis.org/statistics/derstats.htm> and extracts are shown below.

Private non-financial companies (PNFCs) are included in the category of all non-financial customers’ used by the BIS.

PNFCs are clearly only a small part of derivative outstandings. There are many PNFCs. Both common sense and the statistics available indicate that derivative positions of PNFCs individually or collectively do not represent a systemic threat.

All data is US Dollars (billions)—at the end of 2008

Amounts Outstanding of Over the Counter (OTC) Derivatives

	<i>Outstanding</i>	<i>Gross market value</i>
Total	591,963	33,889

of which:

Amounts Outstanding of OTC Foreign Exchange Derivatives

Total	49,753	3,917
Non-financial customers	9,158	737

Amounts Outstanding of OTC Single-currency Interest Rate Derivatives

Total	418,678	18,420
Non-financial customers	41,601	1,061

Amounts Outstanding of Commodity Derivatives

Total	4,427	955
Non-financial customers		Not provided

Amounts Outstanding of OTC Equity-linked Derivatives

Total	6,494	1,113
Non-financial customers	793	142

Amounts Outstanding of Over the Counter (OTC) Derivatives

	<i>Outstanding</i>	<i>Gross market value</i>
<i>Credit Default Swaps</i>		
Total	41,868	5,652
Non-financial customers	494	98

29 January 2009

Memorandum by British Airways

1. BACKGROUND

1.1 British Airways welcomes the opportunity to contribute to the European Union Sub-Committee A's inquiry into the European Commission's communications on ensuring efficient and safe derivatives markets.

1.2 British Airways is one of the world's leading scheduled international premium airlines, carrying 33 million passengers worldwide to 148 destinations. The airline's network generates economic value by meeting the demand for business travel, offering vital arteries for trade and investment, and providing leisure travel opportunities for individuals and families. The British Airways group employs 40,000 people, 86% of them based in the UK. In Financial year 2008–09, it generated £8.992 billion of revenue.

1.3 The group is exposed to variety of financial risks: market risk (including fuel price, foreign currency, interest rate and from 2012 carbon emissions), credit risk, capital and liquidity risk. Aviation is particularly unique as the exposure it faces, particularly from fuel prices, equate to such a large portion of its operating expenditure, 32% in 2009.

1.4 For more than a decade British Airways has utilised the OTC markets to minimise the potential adverse effects of financial market risk on its financial performance. OTC markets are utilised as they permit trading through open credit, which removes liquidity risk. In addition they enable the customisation of hedges to better match our underlying economic exposures and enable compliance with international accounting standards.

1.5 British Airways supports the EU Commission's objectives to improve transparency, accountability and stability in financial markets. However, we do not agree with subjecting non-financial institutions to collateralisation or margining requirements. Non-financial institutions do not have the same access to liquidity that financial institutions enjoy. Collateral requirements would create a significant liquidity risk to our business. Our only alternative would be to dramatically limit hedging activity to the detriment of the financial stability of the Company.

SPECIFIC RESPONSES TO QUESTIONS

2. DERIVATIVES

What economic benefits do derivatives bring?

2.1 Derivatives are key instruments utilised by non-financial corporations to "hedge" financial risks, essentially smoothing out the impact of external influences over which we have no control. At British Airways, this allows us to focus on running our core business.

2.2 The recent market volatility for fuel and currencies is shown in Attachment 1. Both of these markets present significant risk to BA. We use in the region of 40 million barrels of jet fuel per year. With the oil price swing of about \$100/bbl in 2008, this equates to a price risk of \$4 billion, clearly a risk that a prudent company would and must seek to manage.

2.3 Our experience during the last decade demonstrates clearly that our hedging activity has protected the company's liquidity position. It has also given the business the time it needs to react to a rapidly changing cost environment.

3. CLEARING DIRECTIVE

Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?

3.1 Central clearing implies collateralisation and as identified below this will prevent British Airways from adequately managing the financial risks to which it is exposed.

Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?

3.2 While unwelcome, we accept there may be an increased cost element to risk management (hedging) activity in the future from the Commission's initiatives to remove systemic risk.

3.3 We believe this cost is most practically determined through the pricing mechanism within OTC bi-lateral contracts. We believe that in increasing capital requirements on financial institutions who trade derivatives, that they will reflect the increased cost in the spread/price quoted to the transaction counterpart [ie the non-financial institution). In this way the non-financial institution is sharing the cost burden of reducing systemic risk. We are already seeing increases in quoted prices reflecting a credit charge.

3.4 However, we do not believe that there is any justification for highly punitive costs on bilateral OTC contracts for non-financial institutions that adhere to Treasury best practice in having a corporate policy to manage financial risks in their business. Such best practice should be encouraged as a vital element contributing to a growing and healthy economy. It is extremely important that the level of capital charges imposed on financial institutions should be set so as not to ultimately make it cost prohibitive for non-financial corporates to hedge. We believe a detailed impact analysis on this issue is imperative.

4. FURTHER ISSUES

The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?

4.1 We do not believe that systemic risk will be alleviated or controlled by forcing non-financial corporations to trade derivatives through either CCP clearing with margining, or bilateral OTC contracts with collateral requirements.

4.2 The economic effect of the requirement to provide cash collateral/margining is to convert the primary risk for companies from that associated with counterparty exposure into liquidity risk. The adverse effect of the creation of liquidity risk is a reduction in the amount of funds allocated to productive investment in the Company, and curtailment or even elimination of the ability of BA to manage its financial risks (ie hedge) because the liquidity risk generated jeopardises our financial stability.

4.3 We present in Attachment 1 an example of the British Airways position with respect to fuel derivatives at our last year end, 31 March 2009. If margining/collateral requirements had been in place, the cash call to cover the derivative position would have occurred at the same time as the largest economic downturn to hit the airline industry. This would have reduced the cash position to a critical level, in an environment where credit conditions were very tight and the ability to raise additional capital virtually non-existent.

5. SUMMARY

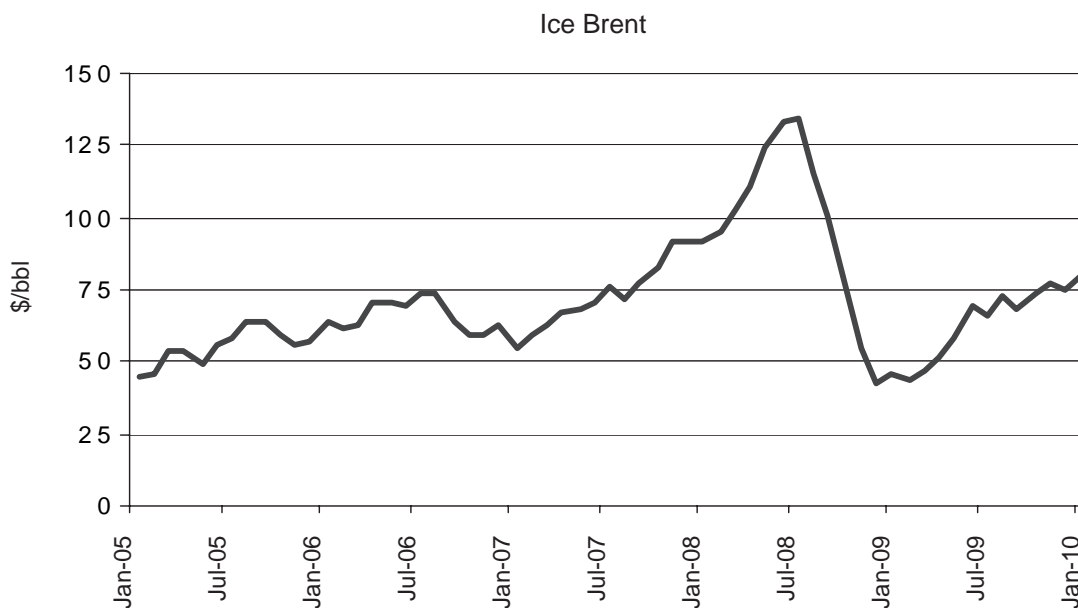
5.1 British Airways supports the Committee's inquiry into the derivatives markets and supervision. We believe the current communications from the European Union poses some threat to the continuation of bone fide risk management activity. The communication affects all European airlines that hedge fuel requirements to provide financial stability for their businesses, and there is widespread concern from airlines across Europe to ensure that the industry is not unintentionally damaged.

5.2 We are a member of the Association of European Airlines and working with our trade body at an European level to secure a reasonable and prudent outcome that maintains the financial stability of our industry.

1 February 2010

Attachment 1

MARKET VOLATILITY	ICE BRENT CRUDE OIL		GBP/USD	
	High/Low	Diff	High/Low	% Diff
	\$/bbl	%		
	2009	80 / 40	100%	1.6981 / 1.3746
2008	146 / 37	294%	2.0336 / 1.4435	41%



**BA IMPACT ANALYSIS:
WHY COLLATERAL REQUIREMENTS/CCP WITH MARGINING ARE DANGEROUS FOR
NON-FINANCIAL CORPORATIONS**

	<i>Financial Year End 31 March 2008</i>	<i>Financial Year End 31 March 2009</i>
Operating Profit	£878m	£(220)m
Net Debt	£1,310m	£2,382m
Market Capitalisation	£2.7bn	£1.62bn
Cash Balance	£1,864m	£1,381m
Fuel Derivative Position	£284m	£(569)m
Cash position if hedges collateralised	£2,148m	£(812m)
Sensitivity to 30% Move in Fuel Price	£490m	£300m

* At 31 March 2009, with a cash position of £1,381 million, the financial stability of the company would have been severely threatened by a requirement to collateralise/margin the fuel derivative position—ie, pay out £569 million in cash to counterparties. Should the market have moved down a further 30%, an additional payment of £300 million would have been required.

Memorandum by Mr John Chapman

CREDIT DEFAULT SWAPS—THE MISSING DEBATE

1.1 The Committee has asked for evidence on outline Commission proposals for making a range of OTC derivatives safer. But these proposals, and parallels in the USA, would not have arisen without the damaging roles of Credit Default Swaps (CDSs), in the financial crisis. CDSs are derivatives for the transfer of credit risks; they are obscure, controversial and potentially harmful in several ways.

1.2 In March last year the Chairman of the FSA recommended that regulation of CDSs should be debated. That debate has not taken place. CDS issues have been debated in the USA, but with limited publicity in the UK. My evidence is primarily aimed at bringing out the issues on credit default swaps, and to present options for CDSs for the Committee. If CDSs were restricted to “covered” CDSs, where buyers have insurable interests, the Commission proposals for Central Counter-party clearings (CCPs) could be backed with more confidence.

COMMISSION COMMUNICATIONS AND UK GOVERNMENT RESPONSE

2.1 In COM(2009) 332 of July 2009 the Commission outlined proposals for CCPs, with standardization of derivatives, central data repositories and trading on more public venues. In COM(2009) 563 of October 2009, the Commission expanded on proposals for oversight of CCPs through conduct of business and governance, risk-management standards, and legal protection to collateral and positions. The posting of initial and variation margins for bilateral clearing, with different treatment for financial and non-financial firms, and higher capital charges for bilateral clearing was also proposed with mandatory CCP clearing for standardized derivatives.

2.2 The Commission also proposed trade data repositories to improve transparency, with the European Securities and Markets Authority (ESMA) having overall supervisory authority. Suggestions to combat market manipulations included giving regulators the power to set position limits.

2.3 The FSA/HM Treasury response in “Reforming OTC Derivative Markets—A UK perspective”—raised doubts over mandating CCP clearing of all standardized derivatives, and over the posting of margins by non-financial firms in bilateral clearing. The response opposed ESMA having a supervisory role over trade data repositories, preferring the OTC Derivatives Regulators Forum for the (New York-based) DTCC. The proposal for limits to combat manipulations was not supported.

2.4 The UK’s somewhat lukewarm response to EU regulation of OTC derivatives reflect London’s key roles in derivatives markets. In 2007 London accounted for 42.5% of world issues of foreign exchange and interest rate derivatives, and New York 24%. As to the controversial credit derivatives, the US market share was 40% and London 37% (1).

2.5 Neither the Commission communications nor the FSA/HM Treasury paper discussed the various issues arising on the controversial CDS derivatives. Nor did they discuss the potential costs to taxpayers of implicit backing for “too important to fail” CCPs, overseeing CDS activities that may be less than desirable.

2.6 In its 15 December call for evidence, the Committee asked for responses to questions including “What risks are associated with derivatives and derivative markets?” and “What role did derivatives play in the recent financial crisis?” Such questions indicate that the Committee is rightly interested in the broader issues raised by derivatives, which have not yet been debated in the UK.

CREDIT DEFAULT SWAPS—WORKINGS, ORIGIN, GROWTH AND USES

3.1 Broadly, a CDS is a deal between two “counterparties” on the credit risk of a specific “reference” asset, with the buyer getting credit protection through periodic payments in return for the seller paying a settlement amount on a specified credit event, eg bankruptcy or restructuring. CDs may be in single-name or index forms.

3.2 The CDS concept was only “industrialized” from 2002 by JP Morgan executives (2). The headline “From nought to 60 in five years” (3) highlights the dramatic growth of gross notional CDS outstanding from very little in 2002 to \$60 trillion at end 2007. There has since been a fall-back to some \$30 trillion by mid-2009, apparently with “compression” of offsetting swaps, but huge sums are still outstanding. (Net positions are much less, perhaps only 5–10% of gross amounts)

3.3 At first sight a CDS deal resembles insurance, in that the buyer pays premiums with the assurance of pay-out on the occurrence of an event. Some buyers of CDS do have “insurable interests”, such as banks taking out CDS on companies they have lent to. Such CDS are called “covered”. But it is not necessary for CDS buyers to have insurable interests. For example, a hedge fund can buy a CDS on a particular company, even though it has no shares or other financial interest in that company. The term “naked CDS” applies to such situations.

3.4 Detail of the actual uses of CDSs is lacking. The ECB comments that “although disentangling the various uses of CDSs is somewhat artificial, one approach has been to distinguish between hedging and trading purposes” (4). CDSs are used to hedge the credit risk of assets (eg corporate bonds) by acquiring the credit risk on them. Commercial banks and other lenders are natural buyers of such protection. CDSs are also used to hedge counterparty exposure, especially in periods of market distress.

3.5 The ECB report continues “CDSs are also used as trading tools, for speculating or arbitrage purposes. The leverage embedded in CDS offers a higher return on equity than acquiring the credit assets outright. In the presence of widening credit spreads, CDS can offer equity-like returns, and are therefore attractive to hedge funds, or even more traditional bond funds”.

3.6 “Second, CDSs also allow the acquisition of uncovered short exposure to credit assets when buying CDS protection. The acquirer of CDS protection effectively shorts the underlying reference assets. (Normal) shorting of cash bonds is considerably more difficult to accomplish with fixed income securities, because it requires the short-seller to borrow the assets, which is usually difficult to accomplish with fixed income securities. Hedge funds are active acquirers of CDS protection.”

3.7 The uses of CDS have also been put more bluntly. For example, “Originally devised as a way to buy insurance against the default of bonds or loans, the derivatives became widely used to speculate or place bets on the direction of credit”(2) Also “While originally used as counterparty insurance, CDSs became a highly efficient way to short an institution—that is, by entering into a swap where one paid a relatively small premium but would receive a large payout on failure—and to do so in a way that was overt and potentially self-fulfilling”—from a Wall Street bank president (5)

3.8 Buyers and sellers of CDS are indicated in Table 1, but the uses made of CDS by the different parties are not known. Some commentators have put the amount of “covered” CDSs, ie those where bodies with an insurable interest in an asset take out credit protection on that asset, at only 20% (6). There are indications that hedge funds have bought less CDSs recently. But in many cases hedge fund business models and strategies are specifically designed to participate in credit transfer activities (7)

Table 1
BUYERS/SELLERS OF CDS (2008)

	<i>Buyers</i>	<i>Sellers</i>
	<i>Market</i>	<i>Market</i>
	%	%
Banks—trading	36	33
Banks—loans	18	7
Hedge funds	28	31
Insurers	7	18
Others	11	11

Source: Deutsche Bank Research/BBA

3.9 According to a 2009 Fitch survey, conducted amongst the 26 banks which play a major role in the CDs market, the five largest members (Goldman Sachs, JP Morgan, etc) are responsible for 88% of the notional amounts of CDS outstanding (3)—a far from reassuring picture.

ROLES OF CDSs IN THE FINANCIAL CRISIS

4.1 The financial crisis arose from the evolution of a fragile shadow banking system:

- commercial banks indulged in securitization, bundling up their loans into securities, passed into off-balance sheet special vehicles, thus evading Basel capital requirements, a machine of unlimited credit was created;
- investment banks devised structured products such as Collateralised Debt Obligations (CDOs) with tranches of different risks/rewards, using mixes of securitized loans “alchemised” into higher ratings, and then sold on;
- investment banks applied CDSs to CDOs to produce “synthetic” CDOS, where only the credit risks, not the loan packages, needed to be sold on;
- leveraged hedge funds led in buying the high-yielding products, with the prime broking arms of investment banks providing leverage and other support to hedge funds;
- banks, insurers and other bodies world-wide joined the rush for the products, against a background of low interest rates; and
- banks found it difficult to sell the low-yielding senior tranches of CDOs, though some obtained protection through taking out CDSs.

4.2 At the first sign of trouble, defaults in the relatively small sector of sub-prime loans, this unregulated system folded like a pack of cards. The rush to the exit by leveraged hedge funds sent CDOs prices in a downward spiral. With CDOs impossible to price, even senior tranches became toxic. With most institutions holding unknown amounts of toxic assets of unknown value, trust evaporated and markets froze.

4.3 CDSs had several roles in the crisis:

- (a) use of CDSs in creating the popular synthetic CDOs made them an integral part of the suspect system;
- (b) when doubts arose, the unwinding of leveraged synthetic CDOs magnified the problem—“Synthetic CDOs played a rather active role in the propagation of the financial turmoil. A rapid unwinding of synthetic CDOs by particular hedge funds resulted in a further widening of credit spreads, as demand for these products collapsed. The process spilled over to other structured finance products” (8)
- (c) CDSs presented a new way of shorting—“As asset prices CDS spreads for affected institutions ballooned, as did traditional short-selling. With CDSs, short-sellers had an additional potent vehicle to speculate in rumors of further trouble and foment broader talk of crisis” (5)
- (d) the mis-pricing of CDSs by sellers like AIG and others, and the failure of such bodies to offset their CDS liabilities, meant that the Federal Reserve had to use very large amounts (\$ 62 billion?) of taxpayers’ money to preserve AIG and contain the crisis; (currently the Federal Crisis Inquiry Commission is examining why AIG obligations to buyers of CDSs had to be met in full).

4.4 EU and US proposals for CCP cover for OTC derivatives are fundamentally directed at avoiding another AIG-type bailout of CDS sellers with taxpayers’ money.

LORD TURNER’S DEBATE HAS NOT TAKEN PLACE

5.1 In the March 2009 Turner Review of the crisis, the FSA chairman chose CDSs as examples of products perhaps requiring specific regulation. He drew attention to particular aspects of CDSs:

- the ability of those without an insurable interest to take out protection against some failure/downturn in some asset or organisation “creates a heightened risk of abusive market behaviour”;
- CDS prices, far from providing a useful market-based measure of credit risk, systematically understate risk in the upswing and overstate it in the downswing;
- the combination of such factors mean that unrestricted CDS trading can introduce significant volatility in the price of credit, which can bring about default events which impose significant disruption costs on the real economy; and
- such effects have the potential to be particularly harmful in relation to banks, where the combination of CDS shorting and equity short-selling can generate a failure of confidence and rising funding costs.

5.2 For his last point Lord Turner had to look no further than the shorting of particular UK banks in the crisis, which must have increased the costs of Exchequer bail-out dramatically. Lord Turner concluded that “The strength of arguments both in favour of and against the unrestricted operation of CDSs should be debated”. But his suggestion has been ignored.

CDS ISSUES IN THE USA

6.1 In the different atmosphere of year 2000, the Commodity Future Modernization Act specifically forbade both Federal and state regulation of CDSs, a step which Alan Greenspan “partially regretted” in 2008. In the post-crisis climate of 2009, there have been several legislative proposals for action on CDSs. “The bills generally sought to impose new record-keeping, reporting, and capital reserve and margin requirements on CDS dealers and major market participants, and to require that standardized CDSs be cleared by a CCP. Some of the bills additionally sought to enable the CFTC to suspend trading in CDSs, to require CDS buyers to own the obligation referenced by the CDS (a ban on naked CDSs), to impose position limits on ‘large’ CDS traders, or to prohibit all CDS trading outright” (9).

6.2 But such proposals were in effect overtaken by the US Treasury June 2009 comprehensive proposals for reforms for CDS and OTC derivatives generally. Standardised derivatives would have to be cleared by a regulated central CCP, with robust margin requirements and other risk controls. Larger market participants would be subject to new reporting requirements, prudential supervision by regulators and conservative capital requirements. Trading data would be reported to a trade repository or to regulators. The Treasury bill is still being discussed.

6.3 A particular US feature is the debate between Federal and state regulators on CDSs. New York State led a movement to regulate covered CDSs as insurance products. The National Conference of Insurance Legislators (NCOIL) has given support, pointing out that covered swaps closely resemble insurance, and that naked swaps are more akin to gaming than insurance as they lack an insurable interest, and resemble directional bets. NCOIL has drafted model legislation to regulate covered CDSs as insurance, but has agreed to defer further action until the adequacy of the final Federal regulations can be assessed.

6.4 Another CDS problem exposed in the US is that of the “empty creditor”, who may force bankruptcy to trigger a CDS pay-off. A University of Texas academic explained to the US Senate Banking Committee in June 2009 that the holder of a debt in a company might have that debt dwarfed by a CDS holding in the same company. Using his control rights from holding debt he could force a bankruptcy if the CDS pay-off was higher than his possible return from a restructuring. The International Swaps and Derivatives Association (ISDA) has questioned whether such occasions really arise, but they appear relevant to actions of Goldman Sachs in the AIG bail-out, of Morgan Stanley in the rescue of the Kazakhstan bank BTA (10), and of hedge funds in the rescue of General Motors. CDSs then pose problems for bankruptcy situations, and governance issues.

6.5 It is also possible that the rapid growth of CDS contracts was in part tax-related. “Tax arbitrage contributed to the explosive growth of profits based on securitization, for example through the use of CDS contracts to switch tax losses on the capital of low quality mortgages from buy and hold investors (who could not use them efficiently) to traders (who could)” (11). A March 2009 paper claimed that “credit default swaps are revealed to be a massive tax arbitrage that shifted government tax receipts to Wall Street bonus pools and necessitated the creation of massive quantities of low credit quality debt” (12)

DRAWBACKS OF CDSs

7.1 Specific drawbacks of CDSs arise:

- (a) False prices—CDS prices understate risk in upswing, overstate in downswing.
- (b) Market fragility—the substantial presence of leveraged hedge funds amongst CDS buyers means that any selling-off may trigger downward price spirals.
- (c) Shorting—CDSs present a cheap and visible way of shorting assets or companies, easier than traditional shorting as assets are not bought, and present a new problem for regulators anxious to stop shorting in times of distress.
- (d) Bankruptcy—an “empty creditor” may engineer a bankruptcy for a CDS pay-off.
- (e) Tax arbitraging—it may be possible to switch CDS tax liabilities/losses to reduce tax.

7.2 Against such drawbacks, it is claimed that CDSs help in price discovery. But CDS prices can be false. CDS prices may also be affected by shorting bets, which can be self-fulfilling and damaging. There is also the hackneyed argument of greater liquidity.

7.3 An overall drawback of CDSs is that a substantial chunk, and even the bulk of them, are used for speculation or shorting, rather than coverage of risks. This would appear to make it even more difficult to support the setting up of “too important to fail” CCPs which implicitly have public backing. If a CCP should struggle, perhaps through its inadequate management of hedge fund gamblers, the necessary taxpayer support would be very hard to stomach.

OPTIONS FOR CDSs

8.1 There appear to be five options:

- (a) abolish CDSs completely, and leave parties to hedge risks as they did before 2002;
- (b) abolish CDSs completely, but use insurance for “covered” situations, i.e where there is an insurable interest;
- (c) retain covered CDSs only;
- (d) allow both covered and naked CDSs, but tax naked CDSs; and
- (e) allow all CDSs.

8.2 Options a and b have the attractions of avoiding the operational drawbacks and the stigma of implicit support for gamblers, but it is not easy to judge the difficulties of reverting to a pre-2002 position or of coverage through insurance.

8.3 Option c presents an attractive compromise. Those with insurable interests could continue with CDSs. The operational drawbacks of fragile markets and shorting would disappear, as would the stigma of implicit public support for gamblers.

8.4 Options d and e would allow all the operational drawbacks, and invite the stigma of implicit public support for gamblers, through backing for CCPs. But option d could bring in substantial returns.

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HOUSE OF LORDS—EUROPEAN UNION COMMITTEE—SUB-COMMITTEE A

Commission Communication on ensuring safe and sound derivatives markets

SUMMARY OF EVIDENCE OF JOHN CHAPMAN

The Commission proposals have been triggered by the damaging roles of Credit Default Swaps (CDSs) in the financial crisis, and the proposal of Central Counter-party clearings (CCPs) is aimed at preventing a repeat of the bail-out of AIG, costly through CDS losses.

CDSs are derivatives for the transfer of credit risks; they are obscure, controversial and potentially harmful in several ways. Last year Lord Turner recommended that the regulation of CDSs should be debated, but that debate has not taken place. My evidence is aimed at bringing out the issues on CDSs, and to present options.

A CDS involves a buyer paying regular premiums to a seller who agrees to a specific payout on a stated credit event, eg a bankruptcy. Where there is an insurable interest the term covered swap applies. But where the buyer has no such interest, a naked swap arises, typically for speculation, or for shorting an asset (bringing a company down by ostentatiously buying credit protection, often allied with traditional shorting).

CDSs grew from nothing in 2002 to huge amounts in 2007, in parallel with shadow banking. In the crisis CDSs had several roles—as integral parts of the fragile shadow banking system, in vehicles whose unwinding led to chaos, in shorting particular institutions, and directly in the heavy losses of AIG which led to some \$60 billion of public support.

CDSs have been much debated in the USA. They have several specific faults relating to false prices, market fragility, shorting, bankruptcy and even tax arbitraging. They also have the overall fault of being largely used for speculation and shorting.

If the Commission proposals went ahead with CDSs allowed as at present and with their several drawbacks, backing for gamblers would be provided through the implicitly public-supported CCPs. If a CCP were to fail, the public money for its support would in effect be used to meet the lost bets of speculators—an outcome difficult to explain to taxpayers.

If, however, CDSs were limited to covered swaps, the speculators would be excluded, and other drawbacks like shorting would also be ruled out.

1 February 2010

Letter from Chatham Financial

We are pleased to submit the following in response to the Call for Evidence issued by Sub-Committee A of the European Union Committee of the House of Lords.

1. What economic benefits do derivatives bring?

Over-the-counter (OTC) derivatives are used widely as important risk management tools by tens of thousands of firms across all sectors of the economy and around the globe. Derivative usage statistics from the International Swaps and Derivatives Association show that 94% of the 500 largest companies in the world and 50% of medium-sized businesses use derivatives. In addition, thousands of smaller businesses use OTC derivatives to manage and eliminate risk. These businesses tailor the specific terms of OTC derivative contracts to offset precisely the risks they face due to fluctuations in interest rates, foreign currency exchange rates and commodity prices. The ability for these firms to hedge risks allows them to more safely maintain and grow their core businesses. The benefits of this prudent hedging activity accrue to the company, its employees, its shareholders and the economy.

2. What risks are associated with derivatives and derivatives markets?

Counterparty risk, or the risk that one's counterparty will not satisfy its financial obligations, is the most noteworthy risk associated with the OTC derivatives market. This counterparty risk can become systemic risk when the default of a very large counterparty threatens the stability of the financial system.

3. What role did derivatives play in the recent financial crisis?

OTC derivatives did not cause the financial crisis; however, AIG was systemically significant and AIG's losses on its credit default swaps contributed to its demise. Further, following Lehman's failure and AIG's government intervention, concern about possible counterparty failures on financial obligations, including derivatives, contributed to problems in the credit markets.

4. *What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?*

All trades between firms whose derivatives positions have the potential to threaten financial stability should be required to be fully cash collateralised or centrally cleared.

5. *Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?*

No. Central clearing or full cash collateralisation should only be mandated for trades between systemically important institutions. Chief among many reasons, mandating central clearing for all standard trades will force non-systemically important commercial end users to divert precious working capital from more productive uses in order to satisfy clearinghouse margin calls. As the Financial Services Authority described it, such a mandate would create an “unpredictable liquidity burden” that, at a minimum, would make cash flow forecasting and business planning very difficult and, at worst, could force liquidation. We would argue that mandatory central clearing for standard derivatives could increase systemic risk by increasing the liquidity risk of companies.

6. *Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?*

Capital reserve requirements should be intended to promote the safety and soundness of the financial system and should be risk based—that is, the size of the capital charge should reflect the actual risk of the contract. Capital charges should not be used as a penalty for entering into OTC derivatives.

7. *What benefits the use of trade repositories bring both in terms of transparency and improved risk management?*

We would propose that international authorities move to mandate and implement the reporting of all trades to central trade repositories, even if agreement on other portions of derivatives regulation has not been reached. Central trade repositories will allow regulators, for the first time, to see the entire derivatives market and will enable regulators to detect the precise location of systemic risk. This information could facilitate a more targeted and effective application of regulation and prevent a more indiscriminate, and potentially harmful, implementation of regulation. The data gleaned from these central trade repositories would be useful in guiding policy makers as they debate and craft the more controversial elements of the regulatory proposals, including the treatment of trades with corporate end users. To prevent uncompetitive practices, central trade repositories should not have the ability to use collected data for commercial purposes and should be regulated as a utility.

8. *The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?*

A limited number of firms have derivatives positions that are large enough to threaten financial stability. Increased bilateral collateralisation for trades between such systemically-significant firms will have the effect of increasing stability and, therefore, should be mandated. However, as corporate end users make up a small portion of the overall market—and the counterparty risk is dispersed across thousands of firms—it is unlikely that these trades pose a threat to financial stability. As such, imposing higher collateral levels for such firms will have a minimal impact on reducing systemic risk. Moreover, mandating increased collateralisation will force these firms to divert precious working capital from more productive uses. As banks are permitted to lend with or without collateral, as appropriate, it is reasonable that banks should be able to extend credit through derivatives, as appropriate. This is an example of an area where further study is needed to determine the composition of the market and, specifically, where systemic counterparty risk is located.

9. *Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?*

There seems to be an international consensus forming around certain portions of the regulatory proposals in Europe, the US and around the globe. Most policy makers agree that any proposal should require the reporting of all trades to a central trade repository. Most policy makers agree that standard trades between dealers and very large market participants should be centrally cleared. Most policy makers agree that customised trades between dealers and very large market participants should be fully collateralised. As significant areas of systemic risk remain in the OTC derivatives market, international regulators should move swiftly in completing harmonised legislation on these less controversial points.

Regulators should, however, proceed more carefully when it comes to the regulatory elements that have been the subject of some disagreement. One significant area of disagreement is the question of what to do about trades with corporate end users. The European Commission has recognised the need to do a study on the potential impact of certain proposals, including the impact that central clearing and margin mandates would have on corporate end users. We feel that this is appropriate and would hope that international regulators, including those in the US, would adopt a similar approach.

We appreciate the opportunity to submit our thoughts on this important matter. We would be happy to answer any questions that the Lady or the Committee may have.

1 February 2010

Memorandum by the City of London Corporation

Introduction

1. London is one of three major international centres for trading financial derivatives, together with New York and Chicago. The City Corporation's annual research report "*The Importance of Wholesale Financial Services to the EU Economy 2009*"⁹ shows that the European Union 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 respectively¹⁰.

2. 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 diversity of OTC derivative products, and client types and needs, the City would oppose a "one size fits all" approach to clearing and trading with requirements that are unduly prescriptive and disproportionate. Not only is it important for firms to have flexibility in their choice of clearing venues, it is also important for the health of the market as a whole that there should be efficient competition between venues.

3. 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, as is stated in the title of the Commission's communication, "ensuring efficient, safe and sound derivatives markets", it is vital to ensure that any new regulatory framework is based on a long-term approach.

4. Whilst there is support, where practicable, 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 because of their bespoke nature. It should also be borne in mind that OTC markets have a tendency to evolve in the direction desired by end users. If, therefore, regulators push too hard for standardisation, the product development process for new products common to the OTC market may be severely damaged.

5. Moves towards encouraging "standardisation" may also reduce the number of non-standardised contracts available and ultimately reduce risk management capabilities rather than enhance them. End users (such as EU sovereign debt management agencies for example) 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. The City would, therefore, urge the focus for standardisation to be placed on processes not contracts.

What economic benefits do derivatives bring?

6. Derivatives have created new ways for firms and investors to understand, measure, and manage risks and therefore, have made a significant contribution to global risk mitigation and to economic growth in recent years. Many firms now consider them part of their risk-management strategy. 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 central clearing parties) and retaining a viable OTC derivatives market. The OTC markets are not primarily used for speculation. Indeed they fulfil a valuable function for investing institutions.

⁹ *The Importance of Wholesale Financial Services to the EU Economy 2009*, London Economics, published by the City of London Corporation, September 2009

¹⁰ 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

What risks are associated with derivatives and derivatives markets?

7. It would be a mistake to conclude that there is a direct relationship 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 multilateral trading facilities will be able to cover the totality and specificity of the risks that a firm faces. Attempts to manage individual 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.

What role did derivatives play in the recent financial crisis?

8. As underlined in the European Commission’s consultation document of July 2009¹¹, OTC derivatives were not a key factor in the financial crisis. While there are clearly areas for improvement, it should be recognised that the OTC derivatives markets have worked well throughout the crisis and were often the only markets that stayed liquid, in contrast to many cash products. For Credit Default Swaps (CDS) in particular it must be emphasised that this market functioned without issues throughout a period that saw the default of major counterparties coupled with a wave of defaults on underlying names as never experienced before. The establishment of the ISDA Determination Committee and the Credit Event Auction process has enabled the market to cope with these challenges. Also, from a pure risk perspective one must note that CDS did actually succeed in distributing credit risk effectively in the system, with even big defaults such as General Motors not causing any banking crisis.

9. Furthermore most back office challenges such as the backlog of outstanding confirmations have been addressed by the industry in cooperation with the regulators over the last couple of years, with 98% of the CDS market now being confirmed electronically, and 86% of all trades being confirmed on trade date—an efficiency that surpasses many cash markets. Additionally trade compression services that are offered by companies such as Trioptima and Markit have cut the outstanding notionals of OTC derivatives trades significantly, eg by more than 50% in the CDS market.

Clearing Directive

- *Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?*
- *What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?*
- *Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?*

10. The City supports 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 “clearing members”, whose capital it is that will be supporting the clearing house and therefore at risk. Central clearing is a complex proposition and if mandatory clearing forces CCPs to clear products that are not suitable for clearing, it could increase systemic risk and increase costs for 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.

11. The City welcomes 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.

12. 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. 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. The Commission should therefore

¹¹ *Commission Staff Working Paper—Consultation Paper: Possible initiatives to enhance the resilience of OTC Derivatives Markets, SEC(2009) 914 Final, 3 July 2009*

provide an adequate consultation/transition period. Access to CCP infrastructure should be granted on fair, reasonable and non-discriminatory terms. Furthermore the location of a European CCP should be decided on the basis of market preference.

Trade Repository Directive

- *What benefits does the use of trade repositories bring both in terms of transparency and improved risk management?*
- *Should the EU regulate the legal framework for the operation of trade repositories?*
- *What provisions and rules should such regulation impose to improve regulation of trade repositories?*

13. The City supports the use of a central data repository for most asset classes and increased market transparency to regulators. It is acknowledged however that it may not be appropriate to have a repository for an asset class such as commodities, which already have a high level of regulatory reporting and where dealers occupy a very small share of the market.

14. Full disclosure of trades and positions to regulators is crucial to ensure they are adequately informed, however making detailed trade information publicly available might undermine the ability of the market to execute large orders. Furthermore many natural participants in interest rate swaps, foreign exchange and commodity derivatives are corporations which 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.

Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?

15. As the derivatives market is a global one, the Commission is encouraged to pursue a globally coordinated regulatory approach, particularly taking into account developments in the US. Proportionality should also be a key element of this approach. In particular the City welcomes the European Commission's 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, there is a need for the Commission to recognise the specific characteristics of this market and to avoid potential regulatory arbitrage.

Are there further areas for regulation that the communications do not cover?

16. A better focus for UK and European policy is to concentrate on the infrastructure underpinning derivative contracts. Regulators and the industry have already done a lot in this area regarding certain types of derivative. For example a lot of work has been done so that credit derivatives are now mostly cleared through the Depository Trust & Clearing Corporation (DTCC) where previously there was no clearing mechanism for derivatives. Consequently focusing more on developing infrastructure, including clearing mechanisms, is probably a better focus—rather than whether derivatives are on, or off, exchange. However, in this context it should not be ignored that the location where derivatives are cleared can give an advantage to some countries over others.

January 2010

Letter from Deutsche Bank

Please find enclosed the responses of Deutsche Bank to the questions posed in the House of Lords Call for Evidence in the Inquiry on the European Commission's communications on ensuring efficient, safe and sound derivatives markets.

DERIVATIVES

1. What economic benefits do derivatives bring?

1.1 Derivatives allow users to manage exposures to price risk of a particular commodity, currency, interest rate, counterparty or equity. These risks can be complex and long-dated. The requirement for customised solutions accounts for much of the growth in OTC derivatives (versus less flexible alternatives in the exchange traded and cash markets). Approximately 90% of the market in terms of notional amounts outstanding (as of Dec. 2008) are OTC derivatives rather than exchange traded.

1.2 About 95% of the world's 500 largest companies use OTC derivatives to manage risk. Derivatives enable non-financial corporations to transfer financial risks to third parties, enabling them to focus on managing their core business. Derivatives support long term planning (eg through an exporter hedging foreign exchange exposure, or an airline hedging jet fuel prices) and enable capital intensive projects to be undertaken (eg through hedging of interest rate risk associated with the borrowings financing the project).

1.3 Interest rate derivatives play a critical role in asset and liability management for a diverse group of end-user clients across the globe, from Governments and their agencies, non-financial corporations, and almost all financial institutions including banks, pension funds and insurance companies. For example:

1.3.1 Transformation of cash flows related to hedging of new debt a corporation may issue. Most investors prefer buying longer maturity fixed rate debt denominated in their own home currency. However, many corporate issuers prefer to pay a floating rate of interest (eg LIBOR) in their domestic currency on their outstanding debt. In order to connect the corporate issuer with the end investor in the most efficient and cost effective way, the interest rate/cross-currency swap was developed. It allows corporates to issue fixed rate debt in the preferred currency of the investor and transform it back to a domestic floating rate, matching the exact cashflows and maturity profile of their debt.

1.3.2 Asset and liability management. Many insurance companies and pension funds have very long dated liabilities resulting from pension and annuity products. These long-dated liabilities have very large interest rate exposures that increase the cost of the liability when interest rates fall. On the asset side of the balance sheet, many insurance companies and pension funds hold equities and corporate bonds which have a very different interest rate risk profile to their liabilities. In order to reduce this mismatch, OTC interest rate swaps are employed to hedge their long-dated liabilities by providing them with products that gain in value when interest rates fall. These derivatives hedges can be critical in maintaining the solvency of insurance companies and pension funds in volatile markets.

1.4 The overall derivatives market has five major classes of underlying asset:

- Interest rate derivatives.
- Foreign exchange derivatives.
- Credit derivatives.
- Equity derivatives.
- Commodity derivatives.

2. *What risks are associated with derivatives and derivatives markets?*

2.1 Market (price) risk and counterparty risk are the main risks associated with derivatives markets. In addition, participants in the market are also exposed to operational risk (the risk of failed settlement for a trade).

2.2 Market risk—Participants in the derivative markets have the potential for gains and losses on the positions taken on. However, if such positions are in the context of a (perfect) hedge, they should not suffer an aggregate profit or loss (eg, if an airline uses a derivative to protect against higher oil prices, and the price of oil actually falls, they may make a loss on the derivative but a commensurate gain on their lower fuel bills). Exchange-traded futures and options generally do not allow for perfect hedging of risks, and as such participants using such contracts to hedge a risk will have some exposure to the underlying position under all circumstances. OTC derivatives allow for perfect hedges to be created.

2.3 Banks have exposure to portfolios of market risk as a result of the trades that they do with their customers. Such risks are dynamically managed and hedged within the bank and by trading between the banks in the wholesale financial markets.

2.4 Counterparty risk—Derivative contracts bind counterparties together for the duration of the contract. The duration varies depending on product type and market segment, ranging from a few days sometimes in FX derivatives to up to 50 years for certain interest rate derivative contracts. Throughout the duration of the contract, a counterparty will build up financial exposure against the other as the price of the underlying assets referenced in the contract change. This gives rise to counterparty credit risk, ie the risk that the counterparty may not honour its obligations under the contract.

2.5 Most non-financial institutions that use OTC derivatives to manage their risks do so without any requirement from their bank trading counterparty to provide collateral against the value of their derivative trades. In effect, the bank extends credit representing the potential future value of the derivative transaction to the end-user and charges an appropriate credit fee for doing so.

2.6 Not only does this reduce complexity for clients who may not have the operational capacity to manage the daily funding associated with collateral calls, but more fundamentally, it frees up working capital for their core business to help them grow their companies.

2.7 However between financial institutions the practice of collateralisation applies. In bilateral collateralisation or bilateral clearing, both parties will mark-to-market (MTM) contracts so as to monitor the evolution of their value. Should the MTM process show that one party has built up a claim on the counterparty it is then entitled to ask the counterparty for collateral in order to mitigate the risk that the counterparty may not eventually honour its obligation or may default during the life-time of the contract. This process is undertaken on a daily or weekly basis between financial institutions.

2.8 Cash is the dominant source of collateral, amounting to 84% of collateral received in 2008 and 83% of collateral delivered. Cash is exchanged on a net basis, ie a single net cash value is calculated for the overall OTC derivative portfolio between the two counterparties in question. Each counterparty therefore benefits from cross-margining (ie build-up of claims in one derivative market segment compensated by build-up of liabilities in another). Government securities are the second source of collateral (9% of collateral received and 15% of collateral delivered). Other sources are corporate bonds, letters of credit and commodities.

2.9 Collateral is only an effective insurance against credit exposure if (i) exposure is calculated frequently, (ii) collateral is effectively exchanged in a timely manner and (iii) it offers a comprehensive insurance against overall potential counterparty credit exposure. Moving from bilateral collateralisation to central clearing by using one or several CCPs is the most immediate way of addressing these limitations, as CCPs require collateral to be posted from all participants.

2.10 When a central counterparty (CCP) is involved, the single contract between two initial counterparties that characterises an OTC trade is replaced by two new contracts—between the CCP and each of the two contracting parties. This process is referred to as “novation” if an existing contract is terminated and replaced by two contracts with the CCP. The original buyer and seller are no longer counterparties to each other; instead, each acquires the CCP as its counterparty.

2.11 Use of a CCP makes sense for systemically important financial institutions—in particular the major dealers but also some of the other large financial institutions that participate in some size in the markets.

2.12 The structure has three clear benefits: (i) it improves the management of counterparty risk, (ii) it allows the CCP to perform multilateral netting of exposures and payments and (iii) it increases transparency by making information on market activity and exposures available to regulators.

3. *What role did derivatives play in the recent financial crisis?*

3.1 CDS were blamed for necessitating the bailout of AIG, given the losses AIG took on CDS positions and the magnitude of AIG’s total positions outstanding. AIG had taken on a large amount of bespoke, less clearable OTC derivatives. The value of such OTC derivatives, and the creditworthiness of AIG itself, declined such that AIG was forced to make significant payments to its counterparties. Without government intervention AIG would surely have collapsed.

3.2 However, the execution and clearing model itself was not implicated in AIG’s failure. Indeed, whilst the move to central clearing of standardised OTC derivatives is to be welcomed, we suspect that this would not have prevented the losses sustained by AIG. The losses sustained by AIG were in fact due to massive corporate failure to manage the aggregate risk taken on by the institution.

3.3 There is little evidence that the collapse of Lehman Brothers was caused by Lehman’s role as a major derivatives dealer. However, it is fair to say that the CDS market provided the transparency through which the market could assess the likelihood of Lehman’s default. Massive loss of confidence in Lehman caused CDS prices on the bank to increase dramatically, which may in itself have added to uncertainty and hastened the bank’s demise.

3.4 It should be noted that the default of Lehman’s OTC derivative obligations was handled effectively and without impact to counterparties to the dealer, despite being the first instance of a major counterparty defaulting on its OTC derivative contract obligations, including CDS and interest rate swaps. Despite concerns at the time, the majority of Lehman’s positions across all OTC derivative markets were risk neutralised and/or novated to other parties very swiftly. Indeed, the global OTC markets have continued to function effectively throughout the crisis, and have not been adversely affected by Lehman’s collapse.

3.5 The interest rate swap market, whilst the largest portion of the global derivatives market, was not found to be a contributor to the financial crisis.

CLEARING DIRECTIVE*4. Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?*

4.1 A uniform pan-European regulatory framework should be developed for CCPs, including high standards for risk management. This framework and its risk management standards should be consistent with global standards also, in particular the US.

4.2 CCPs should not compete on price (ie the amount of margin required for a particular position) rather on the quality of the service offered. An EU Directive could ensure a level playing field for all EU CCPs. Authorisation and supervision to a specified level will give market participants worldwide the confidence that such CCPs are robust and well run.

4.3 Assuming an EU framework can be agreed, it seems most appropriate for CCPs to be regulated at a national level as such entities may ultimately fall back on the support of national authorities in the event of failure of the CCP.

5. What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?

No comment.

6. Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?

6.1 Central clearing should not be mandatory for all standardised derivatives. Certain counterparties (eg non-financials) who do not pose a systemic risk, and for whom use of CCPs would introduce new risks that they are ill equipped to manage, (eg management of liquidity risk) should be exempted.

6.2 Considerations such as liquidity, availability of price information, ability to model and manage risk, member availability for participation in default management process are important criteria for determining which products are eligible for central clearing.

7. Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?

7.1 Non-centrally cleared trades already attract higher capital charges than those cleared centrally. Going forward, it seems reasonable that a capital differentiation should continue to exist between trades cleared on CCPs and those not centrally cleared (non-standardised contracts or standardised contracts ineligible for clearing).

TRADE REPOSITORY DIRECTIVE*8. What benefits do the use of trade repositories bring both in terms of transparency and improved risk management?*

8.1 We fully support the introduction of trade repositories in all OTC derivative asset classes. We view the primary purpose of the trade repository as providing transparency to regulators on the market activity in each asset class, rather than to manage lifecycle events or become the central “golden source”. Where lifecycle event management is a significant issue—primarily within the CDS markets—then the additional functionality provided by a full warehouse is of benefit.

9. Should the EU regulate the legal framework for the operation of trade repositories?

9.1 To satisfy the needs of global regulators in the most efficient and lowest cost manner, regulators should work together to determine a consistent global legal framework that allows a limited number of trade repositories to be built (one per asset class) but enables all regulators to have unfettered access. A high-level European framework could form the basis for international cooperation of relevant European authorities with equivalents in the US and elsewhere. This would ensure that common standards for the operation of repositories are adhered to (eg, operational resilience, transparency, legal basis).

9.2 The same criteria as apply to CCPs in respect of quality of infrastructure and protection of data, should also apply to trade repositories. Relevant regulators should have reasonable supervisory oversight and ensure access to all “major financial regulatory bodies”; definition of which needs to be determined.

10. *What provisions and rules should such regulation impose to improve regulation of trade repositories?*

No comment.

11. *Should trade repositories be supervised by ESMA or by national supervisory authorities?*

11.1 Trade repositories need not be regulated at the EU level, if repositories are operating under a common EU framework and information sharing agreements can be agreed between national EU supervisors.

FURTHER ISSUES

12. *The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?*

12.1 Increasing the overall level of collateralisation of bilateral exposures will become less of an issue as CCPs in interest rate swaps are extended and CCPs in credit derivatives begin to constitute the majority of new trading volumes. Moreover, as new, increasingly collateralised, business replaces old positions the proportion of trades outstanding that are collateralised will naturally increase. It should be noted that the ISDA statistics that the Commission refers to under-represent the proportion of business that is collateralised.

12.2 There will always be a proportion of business that is not collateralised, constituted by counterparties that either cannot (or will not) post collateral. The former would tend to be corporates for whom this could cause liquidity or working capital issues to do so. Those counterparties that won't post collateral tend to be highly-rated public sector institutions such as European supranationals that deem themselves more creditworthy than the banks and therefore don't feel any need to collateralise a position with a weaker-rated credit.

12.3 In cases where no collateral is taken, the dealer is (through taking a conscious decision on creditworthiness of the counterparty), effectively extending a line of credit or making a synthetic loan. It is in the broader economic interest of all, that regulators allow this practice to continue.

13. *Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?*

13.1 Whilst a common international framework for the regulation of OTC derivatives is desirable, the EU should be wary of simply following the lead that has been taken by the US. The EU needs to take the most appropriate path based on full consultation with the industry and end users, and ensure that legislation drafted is appropriate to the risks faced. The EU should not attempt to impose inappropriate solutions on the basis of only those voices in the industry that would stand to benefit from such changes.

13.2 Indeed the EU must ensure that OTC derivatives activity does not migrate out of the bloc given its importance for the EU's financial centres. London, in particular, is the world's largest financial centre for trading of OTC derivatives, accounting for over 40% of all turnover (up from around 30% 15 years ago).

14. *Are there further areas for regulation that the communications do not cover?*

No comment.

29 January 2010

Letter from Eurelectric

DERIVATIVES

The involvement of energy firms, including electricity producers and suppliers, in financial derivatives markets is mainly based, on their need to manage exposure to underlying physical energy spot markets. This need is a direct consequence of the inherent volatility of electricity spot prices due to the non-storability of electricity. As such, trading in financial energy OTC derivatives actually increases stability in the energy market.

While we understand that the intent of the European Commission is to prevent systemic risk or contagion in traditional financial markets (ie to reduce the impact of overexposure to credit derivatives on the wider financial market), we believe that energy companies trading in financial energy markets pose little or no systemic risk to any part of the financial system. The collapse of Enron, for instance, did not cause any systemic spillover effects on energy markets.

CLEARING DIRECTIVE

In principle, central clearing is definitely welcomed by Eurelectric. In reality, however, the use of CCPs as such cannot be envisaged as a panacea but rather as an instrument among others. Market transparency and integrity policy initiatives in commodity derivatives (thus including the energy sector), would in our view contribute equally to making markets sounder and safer.

While central clearing reduces counterparty risks, on the other hand it:

- Produces a risk-enhancing trade-off between reducing credit risk in certain standardized contracts and increasing basis risk by encouraging the use of those standardized contracts to cover underlying risks on a mismatched basis.
- Requires companies to allocate increased amounts of money and margin at CCPs and so increases the cost of managing risk; this would particularly disadvantage smaller market participants.

In Eurelectric's view, even large energy market participants are not well placed to manage this increased liquidity risk, as they do not have the same access to liquidity as financial institutions. This difficulty in managing risks effectively, combined with increased collateral requirements, will substantially increase costs to customers. For these reasons market participants should keep the right to choose between competing services and companies. The electricity sector appreciates the opportunity to clear deals on CCSs, but needs to retain other options because of the requirement to conclude bespoke deals which cannot be standardised and therefore are not eligible for clearing on a CCP. A significant and increasing portion of OTC commodity derivatives volume is already transacted at transparent, automated trading platforms such as brokers, MTFs etc. The market will move towards such venues as it sees appropriate and should freely decide. The services offered by public trading venues will bring some competition with OTC market places (brokers or direct bilateral trades) while also highlighting the complementarities between these two trading channels.

Increasing capital charges applied to trades non-CCP cleared and to non-standardised derivatives

Requiring a significantly higher level of collateralisation in bilateral contracts would, we believe, come at the expense of liquidity, and would imply a high regulatory burden inappropriate for many of the types of counterparty active in these markets.¹² To tie up capital in this way is inefficient and will inevitably constrain investment at a time when Europe requires major renewal of energy infrastructure.

Power companies take the issue of counterparty credit risk extremely seriously and use a variety of risk mitigation techniques other than collateral (eg master netting agreements, parent company guarantees, bank guarantees, letters of credit, etc) which have proved adequate so far. Moreover, agreements generally include a Credit Support clause specifying the rules for collaterals and credit exposures between parties, including, when necessary, the collateral required. We believe there is no evidence of market or regulatory failure in commodity markets—and no case for regulatory intervention insisting on higher bilateral collateral coverage.

Capital charges should not be used as a penalty to incentivize standardisation (which is already an observed market trend), clearing on CCPs and trading on regulated platforms, but only based on potential risks. Since existing collateralisation practices already adequately cover credit and trading risks, such charges would not be justified.

TRADE REPOSITORIES DIRECTIVE

It should be noted that the Third Energy Liberalisation Package already contains record-keeping provisions which could be used to help regulators with their supervisory functions. Furthermore, DG Tren is currently preparing a tailor-made transparency and integrity regime for the energy sector, which in Eurelectric's view will better address transparency issues in energy than the likely DG Markt proposals. It is important that the Commission fully coordinates these two initiatives.

Eurelectric supports the principle of reporting to regulators, but is conscious of the danger that regulatory requirements in this context could become extremely burdensome. A multitude of detailed reporting requirements, especially if non-harmonised and imposed by different national regulators, would impose heavy investment in IT infrastructure. In the energy trading sector, exchanges MTFs and brokers already offer trade data publication on a commercial basis. Regulators should make the maximum use of these existing sources of information (brokers and exchanges could even provide information systematically to regulators), as a way of actively supervising the market while minimising the requests to market participants.¹³

¹² See also *Eurelectric Response to CESR/CEBS Consultation on Commodities*—August 2008.

¹³ See also *Eurelectric Response to ERGEG/CESR Call for Evidence on Record-Keeping, Transparency, Supply Contracts & Derivatives for Electricity & Gas*—March 2008 and *Eurelectric Position Paper on market transparency (as further to the request of the 12th Florence Forum)*—February 2006.

While a trade repository could perhaps be a useful tool to prevent a variety of information requests by national regulators, and could simplify the tasks of market supervision, EURELECTRIC considers that this should not be a tool directly applicable to increase market transparency.

Finally, we believe that transparency regarding bespoke commodity derivative transactions, whether originating from a trade repository or elsewhere, would be of no value to the wider market. Non-standardised products which cannot be aggregated cannot be published without revealing commercially-sensitive information. In any case, such specific products are based on underlying standard products that are available in the market.

With regard to Monitoring Models, Eurelectric is of the view that EU wide harmonisation should be the key principle. However, existing legislation and competences (eg Competition Authorities already have far-reaching powers also in the energy markets) should be taken into account to avoid overlaps or duplications.

FURTHER ISSUES

Giving regulators the power to set position limits

Eurelectric strongly believes that setting specific position limits is not an effective way to identify and deter market abuse in commodity derivative markets, whether they are CCP or bilaterally cleared. We do not see any evidence which demonstrates that prices of commodities can be effectively controlled through the mandatory operation of regulatory tools such as position limits. Moreover, position limits will curb market liquidity and price discovery processes, while limiting the ability of power companies to hedge transactions.

Therefore, the European Commission should undertake further analysis to establish whether imposition of position limits would achieve the desired effect and to ensure that there would not be unintended adverse consequences.

1 February 2010

Letter from Charlie McCreevy, Commissioner for Internal Market and Services, European Commission

Thank you for sending me a copy of the Call for Evidence issued by the Sub-Committee you chair in relation to the European Commission's recent Communications on derivatives markets.

I welcome the interest of your Committee on this important issue, which is essential for the proper functioning of the European financial market.

As you will be aware, with its first Communication and accompanying Staff Working Paper of 3 July 2009 the Commission launched a public consultation on the possible initiatives for derivatives markets. The responses to the consultation are available at: http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/derivatives_derivatives&vm=detailed&sb=Title. The public consultation was concluded by a high level conference held in Brussels on 25 September 2009. The videos and presentations of the conference are available at: http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm#conference. Following this open and transparent process, the Commission drew its operational conclusions—they are contained in the Communication of 20 October 2009.

At this stage of my mandate it is difficult for me to add anything to the two Commission Communications, which I believe are quite clear in their political orientations. It will be now for the incoming Commission further to define its policy by presenting the future legislative proposals. Your Committee may therefore wish to contact my successor once he is appointed to discuss this matter further.

26 January 2010

Supplementary letter from the European Commission

With reference to your written questions submitted to the Commission on 3 February 2010, please find below our answers.

1. *Should it be mandatory for standardised derivatives to be centrally cleared or should incentives be introduced to encourage standardised contracts?*

The two options mentioned are not mutually exclusive, but rather complementary. Capital requirements are

first and foremost established to cover bank's exposures to risks and not primarily as a tool to achieve wider policy objectives, thus they should be proportionate to the actual risks faced by banks. Since market participants' behaviour may involve higher risks to financial stability than those covered by capital requirements, the latter need to be complemented by further policy measures. Two appear important:

- mandatory clearing of eligible 'standardised' OTC derivatives contracts; and
- agreed clearing targets to be set between supervisors and CCPs.

The agreement reached at G20 level and within the ECOFIN Council on the importance from a financial stability perspective to impose a mandatory clearing obligation, confirmed this principle.

It should be noted, however, that if improperly formulated a clearing obligation may provide the wrong incentives and increase, rather than decrease systemic risk. However, in view of the benefits of the mandatory clearing requirement in terms of counterparty risk reduction and of the international agreement, the real challenge will be to structure the obligation in a way that is consistent with its overall objective of greater financial stability, rather than dismissing it because of potential problems due to its implementation. In other words, an effective, balance and viable process needs to be established and it is what the Commission intends to do in its future proposal.

- *Should the same incentives apply to both credit institutions and non-credit institutions?*

As mentioned above, capital incentives should cover banks exposures to risks and should be proportionate to the actual risks faced by banks. In this respect, counterparty risk is in general not correlated to the type of counterparty, but to its creditworthiness.

- *Should clearing exemptions be granted to certain corporate users of derivatives? If so, how can the potential for abuse be eliminated?*

Corporate end-users are in general not systemically important. However, some of them may engage in substantial trading activity in derivatives and may have large open positions. This may expose the financial market to a substantial counterparty risk, so that the default of that corporate end-user would create knock-on effects on the financial market. Having this in mind, systemically relevant institutions, whatever the label characterising them, should not be exempt from the mandatory clearing requirement.

2. *What would be the quantifiable costs and benefits to current market participants such as (i) banks, (ii) corporates with physical positions and (iii) financial speculators of introducing standardised contracts and centrally cleared contracts?*

- *Will the Commission's impact assessment take into account these aspects?*

The benefits will certainly be a reduction of counterparty credit risk, with benefits for the whole system. The single participants to CCPs will also have high netting effects the more CCPs are used. Indeed the current practices foresee an insufficient level of collateralisation, therefore initially the move from a bilateral to a centralised clearing process will involve the provision of more collateral to cover the exposures. It is expected that this cost will be compensated in the long run by the netting benefits.

Non-dealers, ie smaller banks, corporates, asset managers will also benefit from a more transparent market with positive effects on spreads reductions.

The Commission's impact assessment that will accompany the proposal will indeed take into account these aspects.

3. *Is it envisaged that the number of CCP clearing houses will be determined by market forces? Is it important that clearing houses operate in the EU?*

- *What type of supervisory powers could be assigned to ESMA or potentially to a college of supervisors?*
- *Who will be responsible for a CCP should it collapse or require financial support?*

One of the objectives of the future legislation is to ensure safety, soundness and prudent management of European CCPs. Therefore in order to operate in the EU it is important that these high standards will be met. Furthermore, as mentioned in the Commission Communication of 3 July, there are strong reasons for CCPs being located in Europe, relating to regulatory, supervisory and monetary policy concerns. If a CCP is located in Europe, it is subject to European rules and supervision. Supervisors accordingly have undisputed and unfettered access to the information held by CCPs. It is also easier for European authorities to intervene in case of a problem at a European CCP. For example, central banks do not provide direct access to their liquidity facilities to financial institutions located outside their currency areas. Having said that, the possibility to

recognise third country providers on the basis of an equivalence test should not be excluded, provided that the above concerns are addressed.

Another objective is to ensure efficiency in the European post-trading market and remove cross-border barriers. Competition between market infrastructures would most likely have an effect on the future market landscape.

As suggested by the ECOFIN council conclusion of 2 December, the Commission will propose appropriate institutional responsibilities taking into account:

- (i) the pan-European reach and systemic importance of CCPs; and
- (ii) the fact that CCPs may ultimately be supported by fiscal authorities.

11 February 2010

Memorandum by the Futures and Options Association (FOA)

1. INTRODUCTION

1.1 The Futures and Options Association (FOA) is the principal European industry association for over 165 firms and organisations carrying on business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, lawyers, accountants and consultants (see Appendix 1).

1.2 The FOA supports the drive to establish a more robust framework of regulation, supervision and credit risk mitigation with regard to OTC dealings in derivatives, including:

- (a) closer supervision of markets and dealers;
- (b) central counterparty (CCP) clearing of “eligible” OTC derivatives (see s.2.2);
- (c) proportionate capital treatment of OTC transactions (see s.2.3 and para 2.5.4);
- (d) comprehensive trade reporting to trade repositories (see s.2.4);
- (e) proportionate post-trade transparency of OTC transactions (see para 1.3); and
- (f) improvements in operational processes (eg electronic confirmations).

1.3 As to 1.2(e) above, HM Treasury and the FSA, in their comment paper “Reforming OTC Derivative Markets: A UK Perspective” (December 2009) (“2009 paper”) recognised that “*some OTC derivative markets currently have a higher degree of post-trade transparency already available to a wide range of market participants*”; that post-trade transparency price regimes “*will vary on an asset class by asset class basis*”; and that it was “*unclear what benefits additional post-trade transparency can deliver to markets where products are bespoke and, as such, often illiquid*”. (paras 7.26–7.31)

1.4 While the FOA supports EU and US efforts to establish a common framework of regulation for what are essentially global markets, the US approach is—at this stage—intensely politicised and, in some respects, critically different. Any transatlantic consensus on this issue must strike an appropriate balance between delivering safer and sounder markets and sustaining corporate and institutional risk management capability—as reflected in the following statements of the European Commission’s Communication “Ensuring efficient, safe and sound derivative markets: Future policy actions”:

“Derivatives play a useful role in the economy: they can be used to transfer (all or part of) the risks inherent in economic activity from economic agents who are not willing to bear them to those who are.” (Section 1)

“The Commission believes that a paradigm shift must take place away from the traditional view that derivatives are financial instruments for professional use, for which light-handed regulation was thought sufficient, towards an approach where legislation allows markets to price risks properly.” (Section 2)

“The Commission does not want to limit the economic terms of derivatives contracts, neither to prohibit the use of customised contracts nor to make them excessively costly for non-financial institutions.” (Section 2.2)

1.5 The FSA, in para 2.7 of its 2009 paper, while supporting “*the broad thrust of proposals under discussion*”, questioned whether some of the measures “*could have potentially damaging impacts on financial markets*” (identified, as relevant, elsewhere in this submission). The FOA welcomes therefore the Commission’s acknowledgement in Section 2.2 of its Communication:

- that it will “*carry out impact assessments before finalising its proposals*”;
- that it will take into account “*the costs and benefits*” of its policy orientations “*recognising that most non-financial institutions are not of systemic importance*”;

- that it will “*strive to ensure that any future policy option allows non-financial institutions to manage the risks inherent to their business*”; and
- of the need to “*take into account the specificities of certain commodity contracts, eg electricity and gas markets, which are particular in their underlying physical market structure*” (which may be equally relevant in the case of other OTC asset classes).

Any such analysis must, however, take into account the fact that:

- (a) The OTC markets are professional wholesale markets and essential to the risk management capability of both commercial organisations and financial institutions.
- (b) Non-financial firms (end-users, corporate firms, specialised commodity firms) did not cause the financial crisis and are not systemically important. Since a “one-size-fits-all” approach would be detrimental to them and their ability to manage risk and, consequently, for the real economy, the application of the Commission’s policy proposals to them is disproportionate, particularly mandatory CCP clearing.
- (c) One of the key lessons of the crisis was the need to enhance and not (inadvertently or otherwise) reduce the capability of organisations to better manage their risks.

1.6 With regard to the new European Securities and Markets Authority (ESMA), the FOA believes that, if it is to act as a “supervisor of supervisors” free of conflicts of interest and “turf” issues (with the national supervisors), it should not become involved with direct licensing and supervision.

2. SPECIFIC RESPONSES TO QUESTIONS POSED IN THE COMMITTEE’S CALL FOR EVIDENCE

2.1 *Derivatives*

2.1.1 With regard to the economic benefits of derivatives (see Appendix 2), the European Commission has recognised that they are essential to the EU economy in helping to manage and mitigate business risks and costs; and that institutional and corporate counterparties must be able, therefore, to access a broad range of cost-efficient exchange-traded and OTC financial instruments to manage their business and transactional risks—which are often complex and highly individualised.

2.1.2 The risks associated with derivatives are similar to those of other financial exposures, ie market risk, credit risk, operational risk and legal risk, but are exacerbated by:

- (a) leverage, which is mitigated by the continuing obligation to pay and maintain a deposit based on a percentage of the full contract value and calculated daily according to expected market movements) (NB. Leverage also provides the essential economic basis that makes derivatives ideal as a hedging instrument);
- (b) complexity and/or the long-term nature of some OTC products—which may make risk, pricing and valuation difficult; and
- (c) the prevailing degree of market interconnectivity and liquidity.

NB. Current industry and regulatory initiatives are progressively mitigating these risks and enhancing market and systemic safety.

2.1.3 As to the role played by derivatives in the crisis, the FOA would argue that, apart from the CDS markets, the OTC markets were not a cause of the crisis and worked efficiently throughout its duration. However, the crisis did highlight the consequences of counterparty risk, severe loss in liquidity and the risks of OTC markets being, in the US, unregulated or, as in the EU, under-regulated.

2.2 *Clearing Directive*

2.2.1 The FOA supports new market infrastructure legislation, providing it is founded on IOSCO standards, is proportionate in regulatory terms, eliminates member-state regulatory inconsistencies and focuses on, for example:

- robust standards for CCP corporate governance and risk management within CCPs;
- clearing choice and rights of access, subject to prudential criteria;
- the fair and transparent pricing of CCP services; and
- the provision of CCP services without hindrance across the EU.

2.2.2 However, the proposal by the European Commission that CCPs should be licensed by ESMA, but supervised by the relevant member state authority:

- (a) will create needless conflict, duplication and confusion to the regulation of what are increasingly systemically important organisations;
- (b) add further complexity for exchange-integrated CCPS insofar as clearing will be licensed by ESMA, but execution by the member state supervisor; and
- (c) does not take into sufficient account the fact that, in the event of a default by a CCP, “lender of last resort” support will have to be provided by the central bank and funded by the taxpayers of the member state in which the CCP is located.

The FOA agrees with the FSA’s statement in its 2009 paper that, once pan-European standards are in place, *“It is unclear what additional benefits the introduction of authorisation and supervision at a pan-European level, as is being considered by the Commission, can deliver”* (para 4.25).

2.2.3 The FOA would make the following additional observations:

- (a) The final decision determining the “eligibility” of OTC contracts for central clearing purposes must remain with the “risk taker”, namely, the CCP and not, as is currently proposed in the US, with the regulatory authorities. The role of the EU authorities should be to work closely with the industry, including end users, to develop common EU criteria for determining “eligibility” for CCP clearing (see further para 2.2.4); and for the national supervisors to monitor and spot-check CCP interpretation, measurement and implementation of that criteria.
- (b) The FOA is also concerned over the (possible) US intention to impose a 20% cap on bank/dealer ownership of CCPs. Any concern that bank or dealer ownership of CCPs could generate regulatory avoidance can be effectively addressed through regulatory oversight (see (a) above), capital incentives to use CCPs where possible (see para 2.3) and effective management of conflicts of interest (eg Chinese walls, segregation of functions, managerial oversight, independence policies and better use of non-executive directors).
- (c) Maximising credit risk mitigation via CCP clearing is important, but it should not:
 - (i) marginalise the availability of bespoke contracts to manage bespoke risks; or
 - (ii) significantly increase risk management costs (a concern of corporate treasurers); or
 - (iii) compel the use of standardised transactions to manage non-standard risks (ie enhanced basis risk)/reduce the availability of hedge accounting treatment; or
 - (iv) force CCPs to clear products which pose undue risk to a CCP.

2.2.4 The FOA notes that there has been a strong focus on “standardisation” as the determining factor as to whether or not OTC contracts will be eligible for CCP clearing. Clearly, standardisation is a key determinant (both legal, in terms of contract certainty, and economic, in terms of liquidity), but there are other equally important measures for determining CCP clearing “eligibility”, eg pricing transparency, liquidity, volatility, risk complexity, valuation capability and the risk management capability of the CCP. The EU/US shift towards FSA’s approach of clearing “eligibility” is to be welcomed.

2.3 Capital Treatment

2.3.1 Concerns over weak pricing and risk variations between non-CCP and CCP-cleared OTC transactions may generate differentiated capital treatment, but it must be based on those variations and not be driven by policy objectives. Unfortunately, the intention to “incentivise” the use of standardised CCP-cleared products could undermine the Commission’s other policy objective in para 2.2 of its Communication of not wanting to make customised contracts *“excessively costly for non-financial institutions”*.

2.3.2 As stated by the FSA in its 2009 paper *“The UK authorities support capital requirements that are proportionate to the risk they assume rather than being used as a tool to directly influence market structure. We therefore agree with the G20 and the Commission that bilateral arrangements, due to their higher risk, should be subject to higher capital requirements, but we are not supportive of penal, non-proportionate capital changes.”*

2.3.3 The Communication expects that *“the larger part of [the cost of strengthening the market infrastructure for OTC derivatives] will be borne by financial firms”* (Section 2.2)—but much of that cost will be a “pass-on” cost borne by end-users. There may be some “network” benefits, but it is over-optimistic of the Commission to assume that costs will decrease over time. In addition to the “pass-on” costs and as pointed out by the European Association of Corporate Treasurers, there will be a significant and ongoing increase in direct costs generated by the cash-flow burden of meeting daily and intra-day margin calls and requirements to use high-quality and more loss-resistant collateral.

2.3.4 Careful consideration must be given to the economic consequences of imposing “bomb-proof” capital requirements. It is this kind of “trade-off” which formed a central part of FSA’s Discussion Paper “Turner Review Conference Discussion Paper” (DP09/4) and generated its commissioning of a study of the cumulative economic/lending impact of capital and liquidity reforms (Chapter 4)—a study that has equal relevance in terms of assessing market impact.

2.4 *Trade Repository Directive*

2.4.1 The use of trade repositories should give the regulatory authorities better visibility of the macro- and micro-risk generated by dealings in individual OTC markets—providing they afford regulators open and unrestricted data access, irrespective of location.

2.4.2 Trade repositories should be subject to provisions and rules which are (i) harmonised globally; and (ii) directed towards ensuring the adequacy of arrangements for *inter alia*:

- (a) gathering and secure retention of trade data;
- (b) maintaining confidentiality and governing the basis of third-party disclosure;
- (c) aggregating data on positions, open interest, etc. for transparency purposes;
- (d) managing conflicts of interest;
- (e) preventing duplication in transaction reporting; and
- (f) curtailing any unacceptable “monopolistic” consequences that may flow from the industry’s preference for a single trade repository for a single asset class.

In addition:

- (a) the regulatory authorities must be capable of analysing positions reported to them (but the reports will not include data on any underlying positions that are being hedged); and
- (b) dealers should be required to report their OTC transactions either through the existing market infrastructure providers or, as may be necessary, to trade repositories or, in the absence of a repository for a particular class of OTC transaction (eg because for a small market it may not be economically viable), to the regulatory authority directly.

2.4.3 The FOA would prefer trade repositories to be licensed and supervised by their national supervisory authorities in accordance with global standards, rather than by ESMA. However, the key concern is more about the quality of licensing, regulation and supervision, rather than by whom it is undertaken or where a trade repository is based.

2.5 *Further Issues*

2.5.1 The FOA recognises the importance of keeping the Market Abuse Directive under regulatory review. Subject to issues of relevance and proportionality, it may be appropriate to extend its scope beyond regulated markets to cover MTFs.

2.5.2 The FOA notes the intention to provide member states with the “possibility” to set position limits, but is opposed to their use for the following reasons:

- (a) market participants should not be deprived of access to economically free markets unless that participation is unlawful (eg market abuse) or there is clear evidence that, although lawful, it is economically damaging to a particular market;
- (b) there is no current evidence to suggest the upward (or downward) long-term trending of commodity prices has been driven by speculation; and
- (c) there is no evidence to suggest that the preferred UK approach of position management, which includes powers to require firms to close or reduce positions or to close them unilaterally (as opposed to position limits), has been found wanting.

The FOA agrees with the conclusion by the FSA in its 2009 paper that “*Given the complex, disparate and international nature of OTC markets, we consider position limits to be unworkable on a market-wide basis*” (para 9.11).

2.5.3 In considering the impact of financial participation in commodity markets, it should be remembered that:

- (a) financial traders deal in commodity markets for a variety of reasons, eg hedging portfolio risks and/or diversifying the risk profile of portfolios (because commodities move at different times in the

economic cycle to the more traditional forms of investment)—and not just for “speculative” purposes;

- (b) financial traders provide depth and essential liquidity to markets;
- (c) because the trading motivation of financial traders is economically differentiated to that of commercial organisations, their readiness to accept the risk transfer trades of those organisations is critical to risk management and market functionality;
- (d) as it is put by the FSA in its 2009 paper “*We do not consider activity by financial participants to be de facto manipulative*” and that “*The focus should be on combating ‘large positions that lead to manipulation’ irrespective of whether they are held by financial participants or not*”(para 9.19); and
- (e) as it is also put by the FSA in its 2009 paper “*To restrict participation to producers and end-users and to exclude, or even limit, financial players would, in the view of the UK Authorities, be likely to have a controlling effect on market prices, and potentially be detrimental to efficient markets and the price formation process in general*”. (para 9.24)

2.5.4 The FOA supports the Commission’s intention to review the adequacy of collateral in relation to mitigating the risk of non-CCP cleared transactions, but:

- (a) any new collateral requirements should not be set at a punitive level;
- (b) any new requirements should take into full account the nature of the counterparty and the type of collateral that is readily available to them, eg requiring cash collateral would restrict the capability of non-financial institutions to use OTC derivatives to hedge risks; and
- (c) the value and the importance of other forms of credit risk mitigation, eg netting, letters of credit, parent company guarantees should not be discounted.

As it is put by FSA in para 5.9 of its 2009 paper, “*Improving the robustness of the collateralisation processes should be structured to ensure any changes are proportionate to the risk of the users of the system as a whole*” and, the FOA would add, to the nature of the counterparty and the kind of collateral that is readily available to that counterparty.

29 January 2010

APPENDIX 1

LIST OF MEMBERS OF THE FOA

FINANCIAL INSTITUTIONS

ADM Investor Services International Ltd
 AMT Futures Limited
 Bache Commodities Limited
 Bank of America Merrill Lynch
 Banca IMI S.p.A.
 Barclays Capital
 Berkeley Futures Ltd
 BGC International
 BHF Aktiengesellschaft
 BNP Paribas Commodity Futures Limited
 Crédit Agricole CIB London Branch
 Capital Spreads
 Citadel Derivatives Group (Europe) Limited
 Citigroup
 City Index Limited
 CMC Group Plc
 Commerzbank AG
 Credit Suisse Securities (Europe) Limited
 Deutsche Bank AG
 Fortis Bank Global Clearing NV—London
 Fortis Bank SA/NV—London
 GDI Markets Limited
 GFI Securities Limited

EXCHANGE/CLEARING HOUSES

APX Group
 Bahrain Financial Exchange
 CME Group, Inc.
 Dalian Commodity Exchange
 Dubai Mercantile Exchange
 ECX
 EDX London
 European Energy Exchange AG
 Global Board of Trade Ltd
 ICE Futures Europe
 LCH.Clearnet Group
 MEFF RV
 NYSE Liffe
 Powernext SA
 RTS Stock Exchange
 Shanghai Futures Exchange
 Singapore Exchange Limited
 Singapore Mercantile Exchange
 The South African Futures Exchange
 The Tokyo Grain Exchange

SPECIALIST COMMODITY HOUSES

Amalgamated Metal Trading Ltd

GFT Global Markets UK Ltd
 Goldman Sachs International
 HSBC Bank Plc
 ICAP Securities Limited
 IG Group Holdings Plc
 Investec Bank (UK) Limited
 JP Morgan Securities Ltd
 Liquid Capital Markets Ltd
 LMAX Limited
 M & G Investment Management Ltd
 Macquarie Bank Limited
 Mako Global Derivatives Limited
 MF Global
 Marex Financial Limited
 Mitsubishi UFJ Securities International Plc
 Mizuho Securities USA, Inc London
 Monecor (London) Ltd
 Monument Securities Limited
 Morgan Stanley & Co International Limited
 Newedge Group (UK Branch)
 Nomura International Plc
 ODL Securities Limited
 Rabobank International
 RBS Greenwich Futures
 Royal Bank of Canada
 S E B Futures
 Schneider Trading Associates Limited
 S G London
 Standard Bank Plc
 Starmark Trading Limited
 The Bank of Nova Scotia
 The Kyte Group Limited
 Tullett Prebon (Securities) Ltd
 UBS Limited
 Wachovia Securities International Limited
 WorldSpreads Limited

Ambrian Commodities Limited
 ED & F Man Commodity Advisers Limited
 Engelhard International Limited
 Glencore Commodities Ltd
 Koch Metals Trading Ltd
 Metdist Trading Limited
 Mitsui Bussan Commodities Limited
 Natixis Commodity Markets Limited
 Phibro GMBH
 RBS Sempra Metals
 Sucden Financial Limited
 Toyota Tsusho Metals Ltd
 Trafigura Derivatives Ltd
 Triland Metals Ltd
 TRX Futures Ltd

ENERGY COMPANIES

Accord Energy Ltd
 Atel Trading AG
 BP Oil International Limited
 British Energy Trading and Sales Limited
 Chevron Texaco
 ConocoPhillips Limited
 E.ON Energy Trading SE
 EDF Energy
 EDF Energy Merchants Ltd
 Gaselys
 International Power plc
 National Grid Electricity Transmission Plc
 RWE Trading GMBH
 Scottish Power Energy Trading Ltd
 Scottish & Southern Energy Plc
 Shell International Trading & Shipping Co Ltd
 SmartestEnergy Limited

PROFESSIONAL SERVICE COMPANIES

Allen & Overy LLP
 Ashurst
 Baker & McKenzie
 Barlow Lyde & Gilbert
 Berwin Leighton Paisner LLP
 BDO Stoy Hayward
 Cass Business School
 Clifford Chance
 Clyde & Co
 CMS Cameron McKenna
 Complinet
 Contango Markets Limited
 Deloitte
 Denton Wilde Sapte
 Eukleia Training Limited
 Exchange Consulting Group Ltd
 FfastFill
 Fidessa Plc

Financial Technologies India
 FOW Ltd
 Freshfields Bruckhaus Deringer
 Herbert Smith LLP
 Hunton & Williams LLP
 International Capital Market Association
 ION Trading Group
 JLT Risk Solutions Ltd
 Katten Muchin Rosenman Cornish LLP
 KPMG
 Morgan Lewis & Bockius LLP
 Mpac Consultancy LLP
 Norton Rose LLP
 Options Industry Council
 PA Consulting Group
 Patsystems (UK) Ltd
 Pekin & Pekin
 Pinsent Masons
 Rostron Parry Ltd
 RTS Realtime Systems Ltd
 Simmons & Simmons
 SJ Berwin & Company
 Speechly Bircham LLP
 SunGard Futures Systems
 Swiss Futures and Options Association
 Total Global Steel Ltd
 Travers Smith LLP
 Wragge & Co

APPENDIX 2

INTRODUCTION TO DERIVATIVES

INTRODUCTION

“Derivatives” are financial instruments whose primary role is to provide a means of “hedging” against future negative price movements across a range of exposures, including particularly in equities, bonds, credit, commodities, currencies and interest rates and indices. Their value is generally “derived” from the price of one or more underlying assets, rates or indices and, unlike the case with physical dealings, the vast majority of them are cash settled.

Using derivatives to control price risk has been an integral part of trade in commodities worldwide for centuries. Their emergence was generated by the need to develop some form of price certainty in the face of sudden fluctuations in commodity prices caused by, for example, irregular or cyclical production, changing weather patterns or political instability. The dismantling of Bretton Woods, which led to the privatisation of the process of stabilising money rates, resulted in derivatives being extended to cover the raw material of the financial world, namely, money and financial instruments.

USES

- *Hedging*: At its simplest, a hedge is put on by taking a position in a derivative instrument that is equal and opposite in price sensitivity to an underlying cash or physical position or money rate, so that losses in the underlying position will be offset by a commensurate gain in the derivatives position, ie “going short” (to protect an existing position) or “going long” (to protect an anticipated physical position).

In this way, financiers and borrowers can fix the cost of lending/borrowing money; importers and exporters can protect themselves from adverse movements in exchange rates; producers can lock in their profits; factories can hedge against sudden rises in the cost of manufacture; lenders can hedge concentrations of credit risk; and farmers and growers are able to protect their budgeted farm profits. At the same time, managers of equity funds or individual portfolios can use derivatives to hedge

against sudden fluctuations in the value of securities and/or undertake a whole range of investment strategies in diversified markets not otherwise available to them.

In the retail sector, their use has facilitated the development of fixed rate mortgages for homeowners, more stable retail prices for foodstuffs and, for the consuming public, interest-free credit.

- *Trading and Investment*: While the vast majority of market participants use derivatives as risk management/transfer instruments, some organisations trade them with a view to actually taking physical delivery of the underlying asset, others simply trading on price. In commodity derivatives markets, the non-commercial market participants play a fundamentally important role in sustaining high levels of market liquidity and taking the other side of the hedging positions of commercial market participants. This is because the trading motivation of a physical market participant is to protect trade profits, whereas the motive of the financial market participant is to secure a profit on anticipated price movements.

TYPES OF INSTRUMENTS

Derivatives cover a very broad range of contracts, which generally fall into three principal categories:

- *Futures (often called in the OTC markets “forwards”)*: Agreements to buy or sell a commodity, financial instrument or other underlying property for an agreed price, but with delivery taking place on a specified date or range of dates in the future.
- *Options*: Agreements under which one party (ie the purchaser) acquires the right (but not the obligation) to buy (in the case of a “call option”) or sell (a “put option”) a commodity, financial instrument or other underlying property (including other derivatives) at a price (the “strike price”) agreed at the time of the agreement (including an additional payment or “premium” for that right).
- *Swaps*: Agreements to “swap” a series of cash-flows determined by reference to an underlying instrument, product, index or notional amount (eg fixed rate of interest versus floating rate). These are part of a category of product called “contracts for differences” because the underlying product is not capable of delivery and has to be cash settled.

These instruments may generally be traded “on-exchange”, ie on a “regulated market” (or some other regulated multi-lateral trading facility) or off-exchange (otherwise over-the-counter (OTC)). The choice will depend upon the underlying needs of the counterparties and the prevailing liquidity of the market in question.

CHARACTERISTICS

Whether derivatives are traded OTC or on a regulated exchange or some other execution platform, they all have a number of unique and shared characteristics:

- The ability to hedge/profit in falling as well as rising markets.
- The existence of a wide product range.
- Deep, liquid markets in the benchmark contracts.
- The ability to create immediate exposure quickly and often at low cost.
- Contracts can be traded on payment of a small proportion only of the total price exposure.
- Provision of a mechanism for formulating a view on forward prices over a chosen timeline.
- Targeted risk transfer through the blending of different derivative products covering different underlyings (eg bond risk, credit risk, currency risk, etc).

The OTC markets are essentially wholesale professional markets (eg precious metals/bullion, foreign exchange, oil, interest rates, equity and credit), in which derivative contracts are traded bilaterally between banks, other financial institutions and large corporate organisations, often in large size. Most OTC contracts are comparatively straightforward and resemble exchange-traded contracts, whereas others are designed to cover complex underlying risks. The advantages of OTC transactions are:

- They can be tailored to meet the individual needs of the parties (thereby reducing “basis risk” or the risk that the hedging instrument is not precisely matched to the underlying asset or exposure).
- They enable organisations to access products that may not be available on an exchange.
- They enable organisations to choose their own counterparties.
- While the market place is not itself directly regulated, dealings are executed with regulated firms.

- Some OTC contracts are significantly more liquid than their exchange-traded counterparts (ie they can only be accessed off-exchange, such as the foreign exchange market).

Exchange-traded contracts are fully standardised contracts executed in regulated wholesale professional markets and cleared by regulated clearing houses. As such, they offer the advantages of:

- Centrally-regulated markets which are supervised by the relevant national authority.
- Dealings in standardised products which enable buyers and sellers to trade multi-laterally and to open and close positions more easily.
- A clearing house guarantee, which assumes and reduces therefore the counterparty risk of each buyer and seller and protects parties from counterparty default.
- Real-time transparent price formation and discovery and automated transparent post-trade processes.
- Loss mitigation through daily calls for “margin” (ie a deposit based on a percentage of the full contract value and calculated daily according to historic/possible market movement).

Growing convergence across products, increasing standardisation and the complementary nature of the different markets has resulted in some exchanges looking to offer non-standardised instruments; others are providing valuation, collateral management and other “back office” services to OTC dealers; and others yet are offering central clearing facilities for standardised OTC transactions.

Letter from ICAP

ICAP is grateful for the opportunity to respond to the call for evidence by the European Union Committee of the House of Lords. As the world’s premier voice and electronic interdealer broker and provider of post-trade services the company sits at the crossroads of wholesale financial markets.

The company facilitates the flow of liquidity in OTC transactions between commercial and investment banks and other major financial institutions around the world. The Group is active in the wholesale markets in interest rates, credit, commodities, FX, emerging markets, equities and equity derivatives. On behalf of its customers the firm transacts on average EUR1.6 trillion of volume each day.

ICAP owns and operates, outright or through equity stakes, a number of OTC trading platforms and post trade services businesses and has a strong interest in the continuing health, efficiency and safe operation of the global wholesale financial markets.

We have over several years developed electronic platforms designed to increase transparency and certainty of trading and automate and streamline post-trade processes. We regard these as a critical part of market infrastructure, which reduce operational risk for users and mitigate systemic risk in the wider environment.

Many OTC asset classes are already cleared by clearing houses, and accordingly a very significant proportion of the transactions brokered by ICAP (and the majority of the volumes) are submitted to clearing houses and CCPs by us on behalf of our customers. This is dependant on the existence of clearing houses and CCPs that grant non-discriminatory access to eligible trades. The obvious and important benefits of clearing therefore already exist in relation to many OTC asset classes, including OTC derivatives, and we advocate the development of robust clearing models that support these developments.

Having spent many years and not inconsiderable effort and expense to encourage centralized clearing and greater automation, we have also come to appreciate that clearing is not a cure-all panacea that can safely be applied in all circumstances.

One of the consequences of the range and diversity of the OTC markets—itself the result of the range and diversity of investor and borrower requirements—is that second and third order risks arise that cannot be removed by clearing alone. Homogeneity and coherence are two different things; the OTC markets are very coherent (and highly correlated) but their components are obviously not homogenous. Great care must be taken to identify and separate the two: to enforce homogeneity of transaction types would reduce the flexibility available to investors and issuers; by contrast to encourage comparability within coherent asset classes, by improving the speed and accuracy of trading and reconciliation, the netting of payments, the resilience of collateral management, the reduction of settlement periods and elimination of nugatory notional outstandings will serve both public policy and commercial ends.

It would be a mistake, for the reasons outlined above, to regard exchange models of product definition and clearing eligibility as a meaningful conceptual starting point for improving the safety of OTC derivatives markets. Any blanket mandating of transparency and “vertical silo” clearing would be highly detrimental to borrower and investor flexibility and risk management.

Even though both transparency and risk mitigation are entirely the aims of ICAP's business, we should not underestimate the complex interactions involved in OTC markets and the risk of unforeseen consequences of incorrect starting assumptions. It is with this philosophical starting point that we offer our thoughts on certain points in the call for evidence document.

Regarding "vertical silo" clearing—ensuring effective and fair access at all parts of the trading and post trading infrastructure will be key as we move to more centralised models and the introduction of incentivised clearing of eligible contracts. We otherwise risk monopoly structures arising or existing vertical silos being formalised for firms that operate both trading venues and CCPs. To protect against these risks it is necessary to ensure in legislation "non-discriminatory access" to CCPs by competing trading venues.

Today's existing OTC infrastructure depends to a large degree on simplified processes that bring greater transparency and increase robustness where needed. In many products CCP give-up and/or central clearing are already a matter of the contemporary reality.

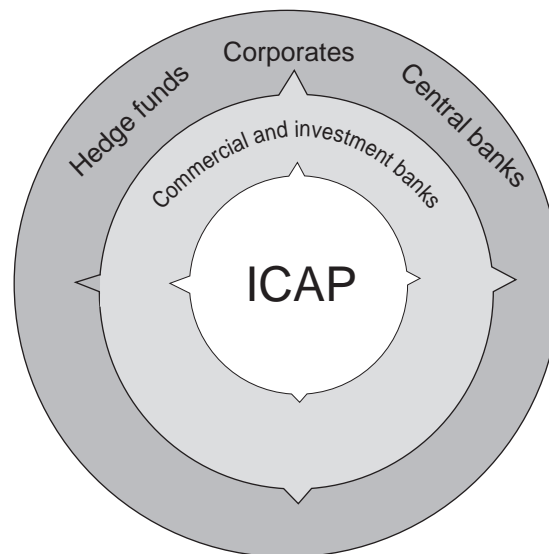
Strengthening the regulatory regime, the tools and scope of prudential oversight, and risk management are of course essential goals. However, in the course of reaching them we must not stifle market appetite or innovation—and as usual we risk the "regulatory lag" that would mean we create regulations that address the last crisis and not the next.

We remain at the disposal of the European Union Committee of the House of Lords to provide additional material where this is required and look forward to discussing these matters further in the near future.

INTRODUCTION

ICAP welcomes the call for evidence by the European Union Committee of the House of Lords. We have participated in the debate among many interested parties regarding derivatives markets that are part of the OTC markets and believe that taking all aspects into consideration will positively influence the debate and its outcome.

ICAP, as an interdealer broker matches buyers and sellers in wholesale markets, so that deals can be executed by its customers—although ICAP's primary role is to bring transparency and focus to markets, due to the nature of much of the wholesale OTC space the starting point is *price availability* rather than price itself. ICAP uses voice broking or electronic networks to facilitate price discovery and liquidity, but in most markets only receives a commission when a transaction is successfully completed.



The majority of markets in which ICAP operates rely on voice brokers to draw together liquidity, particularly in bespoke, less liquid products, where the commitment of capital is thin or transitory. In such markets brokers act to centralise trading interest, create price transparency (which, as noted can be very temporary) and encourage price consensus (which results in a trade—in fact due to the correlations that exist in so many markets, one trade may, and usually does, imply prices in other potential trades, which leads to further price discovery).

More commoditised products, which enjoy more consistent capital commitment from market participants are increasingly traded via one of ICAP's electronic networks—the best examples of what we see as “commoditised” are the US Treasury bond “on the run” maturities (the most recent issues of US public debt in the relevant duration) and the most liquid FX currency pairs that benchmark against USD/Euro. Both these markets display a high degree of legal certainty, large standard size (minimum 1m notional) central clearing (UST via the Fixed Income Clearing Corporation, a division of DTCC and spot FX via the CLS system) and short settlement cycles (T + 1) and each market is a reflection of fundamental economic drivers—USD interest rate yields (ie the benchmark cost of borrowing USD) and the comparable value of assets in key currency zones; all of which lends these markets to fast, consistent and very “clearable” electronic, and OTC, platforms.

ICAP's combined solution offers access to markets across all asset classes and levels of liquidity—markets also develop and flex over time, so the fourth dimension in the shape and behavior of markets must be factored in to the infrastructure to support them. ICAP also provides a range of post-trade services to help its customers reduce operational risk, streamline processes and reduce costs.

An illustration of the operation of the OTC derivatives markets is shown in the slides which are in the Annex to this document.

DERIVATIVES

The OTC market represents a vital risk management tool and as such their use benefits governments, corporations, investors and individuals worldwide. Derivative markets help the real economy in streamlining the risks inherent to their respective business. The diversity of economic activity stretches as wide as the various business models known in our global economies. Without appropriate tools to hedge financial exposure companies will be unable to concentrate on their main task, whatever that may be (airlines, car industry, . . .).

Many of the risks associated with derivatives and derivatives markets have been identified in the past. However, further improvements in the OTC markets and their infrastructure can be made relatively easily. The existing OTC market infrastructure has been market tested and shown to operate very effectively, even at moments of severe market stress. As commented by many this has proven to be in-adequate in some cases. Enhanced educational efforts are needed and are made so regulators understand the benefits of these markets.

ICAP believes that rather than hasty development of new infrastructure, better and more extensive use should be made of the tremendous capabilities of the existing OTC market infrastructure. The “turnkey” development of completely new market infrastructure is unnecessary and will require significant implementation time and incur a high level of risk.

The current debate towards a solution to current problems in financial markets does not lie in attempting to mandate the transfer of OTC trading onto exchanges. An exchange solution needlessly grants the exchange a monopoly on trade execution (which is usually accompanied by restricted access to clearing) which thereby leads to increased trading costs and risk and diminished flexibility largely bypassing the objectives of the current regulatory debate.

CLEARING DIRECTIVE

ICAP believes that regulations should mandate wider adoption of central counterparty (“CCP”) give up and/or central clearing for OTC derivative markets, not specifically for CDS only but all suitable products. In those OTC markets that do not already operate a central counterparty, we believe regulations should mandate wider adoption of CCPs while allowing independence of trading platform access or other market services.

Two words of caution must accompany the desire to put as much as possible in to clearing:

- *Access to CCPs must be non-discriminatory and open*, so that no execution platform monopolises the “entry point” for clearing eligibility; and
- *CCPs are not able to address all risks*, particularly if their portfolios create unexpected concentrations—rather as the world's most sophisticated banks risk assumptions were challenged by the collapse of the US housing market, so too can the risk models of a CCP that has allowed concentrations or imbalances in its risk profile. As already discussed, in certain markets unless there is sufficient legal comparability of underlying trade components, comparability becomes very subjective.

In line with ICAP's experience in working with various CCPs it is our belief that wider adoption of CCPs services would be beneficial to the markets where appropriate.

The risk committees of the CCPs should be responsible for the eligibility of contracts. These risk committees should include a good mixture of market participants as they contribute to the default fund.

A CCP within a virtual silo may not be ideal as there could be incentives to allow certain risks to be taken by a CCP that would not pass the suitability tests of other independent CCPs.

A full adherence to the ESCB/CESR recommendations for CCPs is necessary, while we await the outcome of the CPSS/IOSCO revisions for CCPs.

CCPs should be independent and provide access to competing trading platforms (MTFs) irrespective of location within the EU (in full respect of MiFID). Participation of General Clearing Members should be widely available but under the strict guidelines as stipulated by CEBS. Wider use of CCPs by all credit institutions is desirable as not every firm has the suitable size to become a direct participant.

Zero risk weighting should certainly be enough incentive for using CCPs across different market segments. However, some caution may be needed as some CCPs may not have the adequate setup to benefit from the highest possible rating. Vigilance should therefore be made by the appropriate regulators that CCPs in the rush for additional business, do not compete on risk by decreasing the necessary barriers required to obtain such zero risk weighting.

Where possible the use of a CCP should be encouraged but it is possible that for example some CDS structures form part of a wider and complex strategy on behalf of the buy-side (non credit institution). In that case, the national regulator should retain flexibility to allow exceptions on a case by case basis, under regular review. In any case, if such exceptions should be granted, the compulsory use of a reconciliation service should be mandated.

Experience shows that once central clearing gains traction it has a snowballing effect, drawing liquidity in to a single clearing venue. Perhaps of more relevance is the selection and resilience of the CCP itself. Mandating the use of the first CCP “ready” in any product could produce divisions in clearing pools and reliance on inadequate or inappropriate infrastructure. Consideration should be given to the circumstances in which “clearing pools” held at a CCP can legitimately be moved to a more suitable location.

Discussions with the dealing committee have shown willingness to use the CCP services where it makes sense. However, there remains a large part of the market that will not be centrally cleared but remain highly important to the market. Clearly capital charges for non CCP cleared transactions will need to be at a minimum equal to the cost of CCP clearing (initial margin, variation margin, default fund contributions). ICAP understands that within the Basle Committee discussions are progressing as to what capital charges should be for non-clearable products. Punitive capital charges would however be highly damaging to the users of these products, and as a consequence may have the adverse impact of increasing risk in the real economy. This would be highly counterproductive and needs to be carefully measured and discussed with market participants.

In that respect, ICAP believes that not only capital charges for non-cleared traders are the solution regulators should aim for. The following additional specific changes need to be made in the way the OTC markets operate that will in turn also contribute to better use of derivatives, largely responding to the call for adequate regulation of these markets:

- *Wider adoption of electronic trading.* Electronic trading creates greater price transparency, enables simpler and faster trade capture, affirmation and confirmation, auditability and easier supervision of trading activity. Electronic trading should be adopted for more OTC markets.
- *Quicker settlement cycles in all securities markets.* A T + 1 settlement cycle for all securities markets should be mandated.
- *Faster and automated affirmation/confirmation of all derivatives trades.* The affirmation and confirmation of all OTC trades in all markets needs to be automated and accelerated as close as possible to the trade date.
- *Greater use of pre-booking netting.* In many cases, transactions can legally and economically be netted, rather than settled on a gross basis. This should be mandated as it would materially reduce the operational and credit risks incurred by market participants.
- *Wider adoption of portfolio reconciliation.* More regular and comprehensive reconciliation of OTC trade details and valuations between counterparties should be mandated.
- *Wider adoption of portfolio compression in derivatives markets.* More regular and comprehensive compression of derivative portfolios, ideally on a multi-lateral basis, should be mandated to liberate capital and reduce risk.
- *Automation of bilateral transactions.* When considering the hedging of risks, one must consider both the economic risk and the operational risks that stem from the act for trading itself (second, third and further orders of risk). Clearly the OTC environment has to contend with multiple assets, with

differing settlement criteria, different bases for calculation, reference assets and currencies. Current OTC derivatives business is primarily settled and margined on a bilateral basis with the relevant counterparty. While operational, credit and other subjective reasons means that bilateral trades will continue to be required by banks, investors and borrowers, risk stemming from the legal and operational accuracy of collateral management should be addressed. There is potential for more bilateral automatised clearing. This will allow systems of banks to be connected, facilitate more accurate and frequent collateral management and provide consistent information to regulators for analysis in data depositories.

TRADE REPOSITORY DIRECTIVE

ICAP supports the need for legislation in this area providing a common legal framework for trade repositories. Because of the specific nature of this service a EU regulatory framework only would not be adequate and bypass the benefits of this regulatory supervisory tool. As shown in recent years, market disruptions can start anywhere and in any category of business, fastly expanding globally. We are concious of the need for access by European regulators of trade repositories. This should be achieved globally by adequate changes in the data provisions under international law.

A company partly owned by ICAP called TriOptima has recently launched the OTC Derivatives Interest Rate Reporting Repository for banking regulators. Extensive discussions have taken place between the dealing committee and the regulators. Currently TriOptima is regulated by the Swedish Financial Supervisory Authority. Frequent contacts are established with many other regulatory bodies including the Commission Services, UK FSA, CESR, the US Federal Reserve, Bank of England, ECB to name but a few. As such current regulatory requirements are fulfilled and established.

The service provide by TriOptima is in effect a comprehensive central data repository covering all asset classes and all product types but currently limited to the participating institutions (buy & sell side). Consequently further expansion of the service allowing an optimisation of trades submitted will create a comprehensive European (global) central data repository service.

To satisfy national regulators the repository agency(ies) could be asked to report on individual companies participating in the vehicle, allowing the national supervisor to monitor the outcome of what should be an up to standard collateral management as the ultimate goal of the exercise.

FURTHER ISSUES

ICAP is a global company with wholesale clients located in more than 50 jurisdictions. Current EU regulatory initiatives need to be sufficiently harmonized. This would fulfill the goal of the G20 ie create a more robust financial system without regulatory arbitrage or business migration.

We believe that adequate tailor made solutions for specific products within each category (FX, fixed income, commodities, derivatives, energy, shipping, . . .) have a proven track record that they improve the efficiency of trading. This takes time and requires a lot of investment in electronic solutions. The first requirement is to have adequate liquidity. The ultimate drivers in this process are efficiency and cost reduction.

As ICAP has seen in a range of commodity and energy sector products, the immediate adoption of a hybrid solution (using a combination of electronic and voice broking) is possible. This provides an automatic electronic trail of information to facilitate straight through processing solutions. The authorities should encourage, as regards product innovation, immediate use of the advanced tools available in today's markets.

Gradual changes in existing products with the adoption of the framework will bring additional benefits to the market. There is a risk of trying to fix what is not broken. The most basic of financial products, the exchange of one currency to another is a good example. As international trade increased the need for currency exchange, volumes increased rapidly particularly as exchange controls became obsolete in most jurisdictions. Wholesale market participants moved into electronic trading because of the size and frequency of trading made it prohibitory expensive to continue trading in the traditional way. Encouraged by the central banks CLS Bank was created. Note this happened not by regulatory or capital charge related pressures but by a constructive dialogue between the market participants and the authorities regarding the goal of this purpose built settlement bank. Recently the transactions flows have become so large that an additional market innovation—that of very near trade reconciliation -has been included within the FX settlement (Triana <http://www.traiana.com>). With the benefit of near real-time reconciliation there is the prospect of aggregation of trades, which removes operational risk and accelerates the reduction of counterparty and market risk.

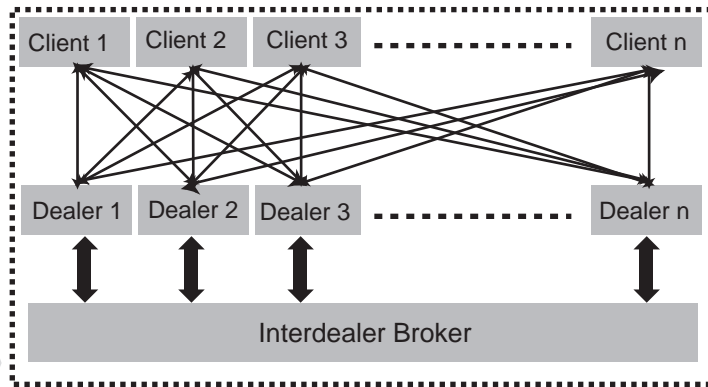
OTC Market Structure

Dealer to Client markets

- Dealers service their client inquiries both by voice and with electronic trading platforms like Market Axess, TradeWeb or bank owned platforms

Wholesale markets

- Also referred to as the Interdealer Market
- Dealers use their capital to make prices and participate as market makers to find liquidity
- Dealers offset risk from client trades in the wholesale markets
- Prices are distributed to other market participants by Interdealer Brokers
- Dealers execute trades both by voice and with electronic trade execution platforms provided by Interdealer Brokers
- Dealers also trade bilaterally with one another without going via an Interdealer Broker



Combined Electronic and Voice Trading

Interdealer Brokers

- At the hub of the OTC markets are Interdealer Brokers who are neutral intermediaries that provide deep liquidity pools, price and volume discovery for trading to professional wholesale market participants.
- Develop significant global communications networks which are used by banks for trading.
- Develop high speed electronic trade execution platforms using similar technologies to exchanges. Full auditability.

Electronic trade execution - direct

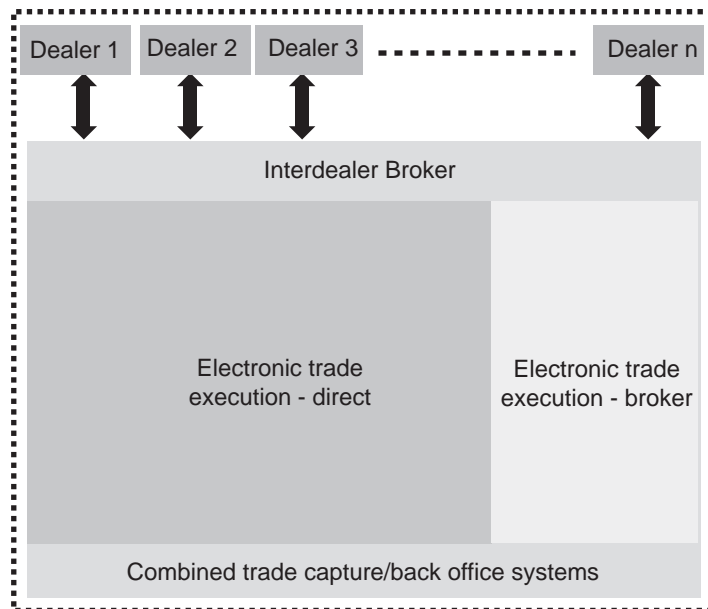
- Traders access trading system directly
- Simple or "vanilla" products
- Smaller-medium size, short dated
- More regularly liquid products
- Eg US Treasuries, Spot FX, US\$ and Euro Repo and some CDS. In future interest rate derivatives

Electronic trade execution - broker

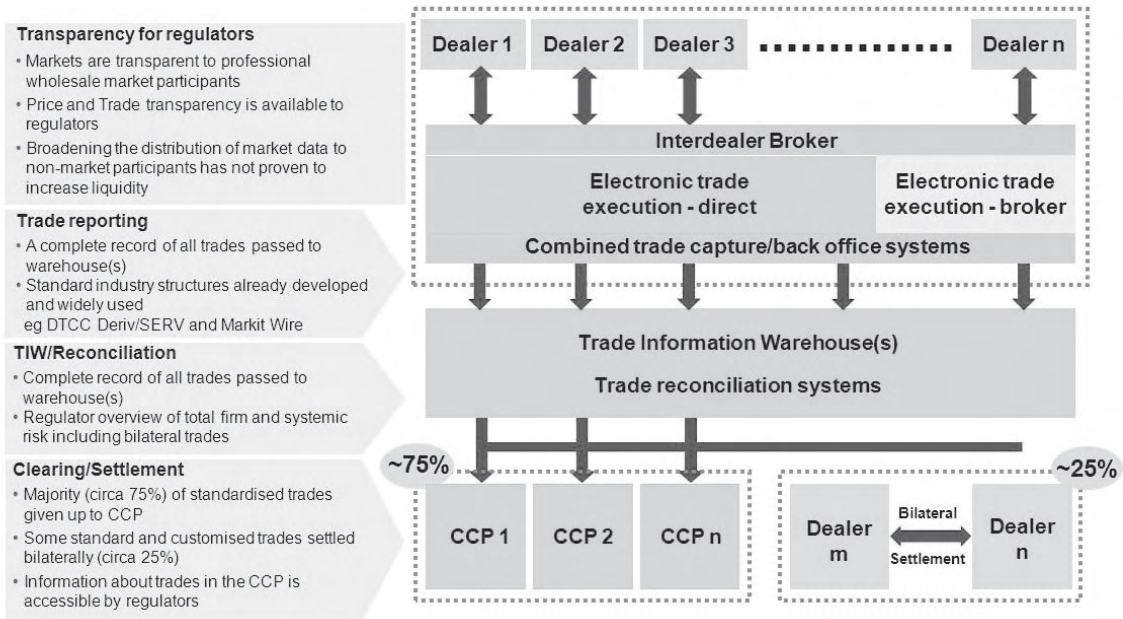
- Traders access system through broker
- More complex products
- Not continuously liquid
- Larger size, longer dated, lower volume
- Eg some CDS, interest rate derivatives, FX derivatives, corporate bonds

Interdealer Brokers

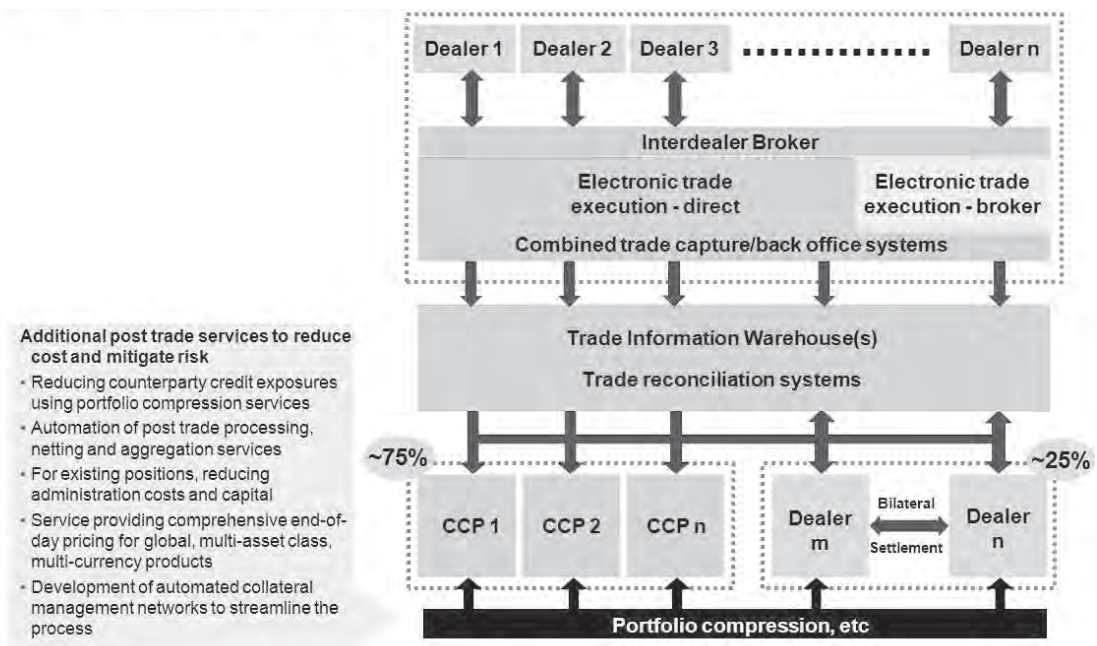
- Electronically capture trade details and provide straight through processing of both direct and broker trades



Transparency of Interdealer Brokers



Increased Post Trade Efficiency



Memorandum by Investment Management Association (IMA)

1. We welcome this opportunity to submit evidence on the European Commission's Communication on OTC derivative markets published in November 2009.
2. The IMA represents the UK-based discretionary investment management industry. Our members include independent investment managers, the investment arms of retail and investment banks, managers of occupational pension schemes and managers of authorised funds (collective investment schemes). Our members are responsible for the management of about £3 trillion of assets, all of which are owned (globally) by underlying clients including pension schemes and individual investors.
3. Our members' interest is as users of derivatives and derivatives markets on behalf of their underlying clients. A significant factor in the management of client assets is to ensure the long term security and growth of investments and savings. In that regard, investment managers' interest is in market stability, but also in competitive choice and cost effectiveness within a market.

GENERAL COMMENTS ON THE COMMISSION'S COMMUNICATION

4. Whilst in principle investors support the move to central clearing of much of the OTC derivatives market, they believe the time frame for bringing about change to the OTC derivatives market structure should be years not months, to allow a proper consideration of all the relevant issues. These issues include legal (contractual, property rights, trust arrangements), operational (systems, operational certainty, margining, contract portability, client and regulatory reporting) and trading (derivative structures, cost).
5. Investors have a significant concern that the timetable for change is unrealistic—and that they will be the losers. In particular, they are concerned that their interests will be overlooked in the rush to ensure that the counterparty (broker) side of the market is brought into central clearing. If the initiative does not also focus properly on investor needs, it will at best achieve only part of its purpose—that of risk management affecting banks/market makers—and fail the other part—market stability, as this affects investors.
6. The infrastructure changes needed to bring about central clearing are not insignificant and will increase project and operating costs across the market to deal with them. It is important, if resource and costs are to be kept manageable, that the market changes should be finalised in all respects before being introduced, rather than being driven by an arbitrary deadline.
7. Investors have a significant concern that the market will fragment, namely that the consequence of introducing multiple clearing houses and methodologies for clearing derivatives will be to increase the cost such that it becomes uneconomic to use derivatives. This would be a perverse and unfortunate result. Currently it is impossible for investors to make an assessment of the relative cost, security and complexity of clearing derivative contracts compared to the current bilateral arrangements or indeed possible future bilateral arrangements.
8. We therefore strongly believe that the work to deal with client-facing issues should be decoupled from the work underway to bring counterparties (that is, banks and brokers) into central clearing; and work to a different timetable. This would allow the requisite time to ensure that the client side of the market has its interests properly considered and dealt with by regulators and each CCP. It would be rash and counter-productive to fail to give the client side of the market the same attention as the dealers/intermediaries.

DERIVATIVES

Economic benefits of derivatives

9. There has been much published on this subject over the years. From the point of view of investors, the key benefits include:
 - Allowing specified risks within a portfolio to be spread or dissipated.
 - Allowing the risk profile of an overall portfolio to be modified.
 - Allowing investors greater speed and choice to perform asset switches, including in size.
 - Having this additional tooling available at relatively modest cost compared with attempting to replicate the same effect through holding underlying assets.

Risks associated with derivatives and derivatives markets

10. The key risks faced by investors in respect of derivatives are that:
 - The risk may be poorly understood and the wrong instrument acquired, leaving the risk essentially uncovered.

- The risk (and therefore the instrument) may be mis-priced.
- Counterparty risk may be insufficiently dissipated owing to poor quality legal terms and collateral management.

11. In respect of bilateral derivatives markets, the risks have been well documented by many, including the Financial Services Authority in the *Turner Review* (March 2009) and more recently in their joint publication with HM Treasury *Reforming OTC Derivative Markets* (December 2009). The risks identified include shortcomings in the management of counterparty credit risk, the absence of transparency in the market and the possibility of a “domino” effect in the market caused by financial firms connected through non-transparent OTC derivative contracts. We agree that these risks exist and that, unmitigated, they may give rise to systemic risk.

12. In respect of organised derivatives markets, by which we mean derivatives performed on exchange rather than the bilateral contractual arrangements referred to above, we perceive the risks to be different, and to include the following:

- The contracts available through organised markets such as exchanges do not cover all the needs of investors and therefore provide a partial solution only.
- The clearing systems, in which only the broker will have membership, do not always offer the required benefits to investors (in particular contract portability and client asset segregation).

13. If more trading/settlement were to be moved to organised markets, investors would need absolute clarity on the following issues: contractual certainty; certainty that asset segregation has occurred if so required (ie client assets segregated from the counterparty’s house assets); and portability of contracts (to another counterparty) in the event of counterparty default.

CLEARING DIRECTIVE

Supervision

14. We support the supervision of clearing houses at national level on a day-to-day basis. Supervisors should be available to deal with issues as these arise, as well as establishing a mechanism to check that supervisory requirements imposed on clearing houses are met on a continual basis.

15. Having said that, we would also support having agreed operational and prudential standards for CCPs imposed across the EU (and preferably beyond). The Bank for International Settlements has already done much work in this area, over many years, and we believe this is a good starting point for a more coherent regulatory regime for CCPs. A directive could of course ensure the imposition of these standards on a mandatory basis across the EU.

16. Regulators should consider with a critical eye the requirements to be imposed for ensuring that the CCPs are fit for purpose. CCPs should not become “too big to fail”—or too big to challenge. There should, we suggest, also be further work to establish whether a CCP should have access to central bank support and in what circumstances. This should not be left to chance or be worked upon only in the context of a future default.

Rules for CCPs

17. We comment on only one item. It is important that rules on governance explicitly deal with contract eligibility. Market stability requires that risk management in a CCP is not subject to commercially driven interference. This tenet will become ever more critical as the size of the centrally cleared markets expands. Whilst it is to be expected that the Board of a CCP will propose and make final decisions on new eligible contracts, the CCP risk committee should be allowed to do the risk assessment for a new contract unfettered by purely commercial considerations.

Mandatory central clearing

18. We do not believe that central clearing should be made mandatory; rather, it should be incentivised, for example by variable capital treatment of centrally-cleared versus bilateral contracts. This is the only way in which a reasonable separation between vanilla and complex products is likely to be achieved. How a derivative product is ultimately packaged, and cleared, should be a matter of choice and cost assessed by the investor, and not forced artificially into a one size fits all structure.

19. We highlight a risk that for complex derivative structures the counterparty risk could be increased rather than reduced by requiring mandatory central clearing. For example LDI—Liability Driven Investment—strategies, used principally for pension funds, will usually feature several elements dealing with different types of risk. It is quite possible that one part of the contract, encompassing vanilla interest rate swaps, could be

eligible to be centrally cleared; whilst a second part dealing with inflation swaps out to say 50 years may not be. In that case the investor would have to post gross margin to both the clearing house and the bank counterparty, rather than as now being able to net the risk with the bilateral bank counterparty. In this case the ultimate client—a pension fund—would be left carrying excess risk.

20. Investors would wish to receive two explicit benefits from central clearing: contract portability in the event of a counterparty default; and a proper segregation of client assets both from the counterparty's house account at the clearing house and prospectively from other client accounts held by the clearing member. It is not clear that either of these benefits will be offered automatically by CCPs. IMA has sought to obtain further information from the CCPs about how central clearing will work in practice for investors, but much remains unclear. It would be problematic were central clearing to be made mandatory without respecting important investor needs.

21. The rules governing each CCP should therefore make the position clear as regards investors, dealing explicitly with the outcomes, in the event of a bank/broker default, as regards contract portability and segregation. These rules should then govern the contractual terms which are concluded with the investor, whether directly with the CCP or (as now) indirectly with the counterparty clearing member in relation to central clearing. In addition, the CCP would need to consider and deal through its rules with laws on privacy as these touch the end-client.

Capital charges

22. Capital charges should be applied not to promote a certain type of market behaviour, but rather to deal with the perceived risks of the activity undertaken. The application of capital charges to bi-laterally cleared contracts should therefore be determined by the assessed risk, rather than being applied on a relative basis to a CCP.

TRADE REPOSITORY DIRECTIVE

23. There could be benefit in a legal framework and supervisory regime for trade repositories being specified at European level, so long as this does not also require different derivative markets to operate with a trade repository in them.

24. Currently trade repositories are part of the market infrastructure for certain products, in particular credit derivatives. In those markets they handle some aspects of the market underpinnings (contractual certainty, information flow, potential transparency to regulators and the market). But they are not necessarily used in central clearing, nor indeed in other derivative markets. Although they are likely to have an important role in the markets in which they are already embedded (principally credit), it does not follow automatically that they will or should have the same role in other derivative markets, for example equity or interest rates.

25. As the central role of a trade repository has to date been defined by the market which it serves, we suggest that it is dangerous to convert that role into something else without a very careful consideration of the consequences for the whole market. They are not there merely to provide information to regulators. Moreover, regulators would need to be very careful that they had the whole picture for the market; it may be that they can get a better picture by use of information from several sources. They may, for instance, need to consider information on underlying positions being hedged and these could not be identified through a trade repository.

1 February 2010

Memorandum by J.P. Morgan

GENERAL

1. *What, economic benefits do derivatives bring?*

1.1 Derivatives can be used to manage a variety of risks inherent in a given business model. For example, the reason many corporates use derivatives is to hedge their cost of borrowing or the operating risks of their business. The risks encountered within businesses vary and both standardised and non-standardised derivatives can be employed to manage risk, with the latter capable of being tailored to exactly meet a particular risk profile. Derivatives are routinely and widely used by a range of entities, including supranationals, central and local governments, banks, investment and insurance firms, as well as corporates, to share and redistribute risk and play an important role in our economy.

2. *What risks are associated with derivatives and derivatives markets?*

2.1 Risks associated with derivatives include:

- Market risk—ie the risk of an asset declining in value as a result of adverse market movements.
- Credit (or counterparty) risk—ie the risk that a counterparty will fail to pay or deliver what is due from it under a derivatives contract.
- Operational risk—occurring as a result of operational errors or lack of risk management process.
- Concentration risks—risk of a very large exposure to a counterparty or group of related counterparties.
- Foreign exchange risks.
- Leverage.

2.2 Risks associated with the derivatives markets include:

- A counterparty not understanding the risks being taken on when entering into a derivatives contract.
- A counterparty entering into derivatives contracts and not having an adequate risk management process in place to manage that risk. If the counterparty is systemically important, this could result in system wide stress.
- Insufficient macro or micro-level information regarding derivative exposures being available to regulators and/or such information being regarded as more complete than it actually is in light of underlying positions not being reflected and thereby adversely affecting proper macro or micro supervision of firms taking place.
- A lack of regulatory oversight over significant non-bank derivative counterparties, leading potentially to systemic instability (ie AIG).
- Central Counterparties (CCPs) with inadequate governance and/or risk management frameworks, leading potentially to systemic instability in the event of default of a member where the cost of close-out exceeds the relevant CCP's financial protections.

3. *What role did derivatives play in the recent financial crisis?*

3.1 The key causes of the credit crisis involved excessive leverage and risk-taking by market participants beyond what was prudent in relation to their capital base due to, amongst other factors, the use of inadequate risk models.

3.2 The largest failures were experienced in relation to structured products with underlyings based on cash flows originating from mortgage activity, such as Collateralised Debt Obligations and Mortgage-Backed Securities, driven by faulty credit valuations and lax underwriting and lending standards.

3.3 Another important factor in the credit crisis was the liquidity shock caused by the drying-up of interbank lending.

3.4 OTC derivatives were not a central cause of the financial crisis, however, the crisis highlighted the need to enhance the transparency of aggregate OTC derivatives transaction volumes and position statistics to the regulators to ensure that the regulators are able to view and assess the overall risk exposures in the financial system at any point in time.

CLEARING DIRECTIVE

The Commission intends to produce legislation regulating the activities of central counterparties (CCPs) with the objective of eliminating national regulatory discrepancies, improving risk management and creating a single European market, for CCPs.

4. *Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?*

4.1 We understand the desire of supervisors in the EU and US to develop an enhanced regulatory framework for OTC derivatives and believe, given the global nature of these markets, that the market safety and stability agenda will ultimately be best served through the development of harmonised global regulators' standards for CCPs and we welcome regulatory oversight which supports this approach.

4.2 With respect to the issue of whether supervision of CCPs should operate at a national or EU level, we would recommend that sufficient time be given to determining whether similar proposals for the regulation of Credit Rating Agencies at the level of the new EU supervisory authorities are effective, particularly at promoting global standards, before further steps are taken with regard to CCPs.

5. *What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?*

5.1 We believe a principles based regulatory regime for CCPs should be focused on ensuring the adequacy of:

- effective and consistent risk management, including, for example, initial margining requirements amongst CCPs, coupled with robust governance arrangements;
- a transparent and robust default management process that provides for orderly and timely close out of a defaulted member;
- strong membership base, supported by minimum eligibility criteria (will vary by product and jurisdiction) and an effective CCP monitoring program;
- strong ownership;
- robust operational controls;
- strict legal enforceability of close-out netting, novation and collateral; and
- robust and effective local regulatory oversight within the given jurisdiction in accordance with globally developed standards.

J.P. Morgan would not support CCPs which did not meet these safety and soundness standards.

5.2 We see these standards as playing a key role in the authorization process of CCPs and would encourage further discussion on implementation as risk management standards need to be robust in both theory and practice.

5.3 We support the revised ESCB-CESR Recommendations for Securities Settlement Systems and Central Counterparties.

6. *Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?*

6.1 We do not believe central clearing should be mandatory for standard derivatives for the reasons set out below:

6.2 We support, in principle, measures which promote the use of CCPs. However, while OTC derivative contract terms may be standardised, for the safety and soundness of CCPs, only standardised liquid OTC derivatives contracts should be eligible for clearing. The introduction of any OTC contracts which are less liquid and harder to value with the high degree of precision required by the CCP, exposes the CCP to the risk that (i) its margin calculation underestimates the actual risk of the less liquid contract and/or (ii) it is unable to sell down its illiquid exposure when necessary, thus exposing the CCP to the potential of unsecured credit exposure to its counterparties. This is destabilising to the CCP, which creates risk for the system.

6.3 In addition, we believe there are a number of circumstances where it may be appropriate for firms to bilaterally settle clearing-eligible contracts, driven by counterparty specific risk and collateral management factors, including whether the counterparty is able to post collateral. From a firm's risk management perspective, recognition should be given to the importance of the decision regarding whether to bilaterally settle or centrally clear. Firms should be allowed to settle clearing-eligible contracts bilaterally if, as part of their own risk management process, they become concerned over a particular CCP's actions or practices.

6.4 Finally, we believe that, forcing non-Systemic market participants ("end-users") to clear their standard OTC derivative contracts with major market participants will result in either (i) the end-user suffering a drain on their working capital as they divert potentially scarce cash to serve as margin at CCPs in support of their risk management activities or (ii) the end user choosing or being forced to leave significant financial risks unhedged because they cannot afford to manage these risks.

7. *Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?*

7.1 We would refer you to paragraph 6.3 above in relation to settling clearing-eligible trades bilaterally, rather than through a CCP.

7.2 There is currently a significant difference in capital requirements between non-cleared OTC derivatives and centrally cleared derivatives, in favour of the latter. This difference is reinforced in recent proposals by the Basel Committee to increase counterparty credit risk charges for non cleared derivatives. The proposed

changes are currently being consulted upon and, we expect, will provide sufficient incentive to centrally clear derivatives where it is appropriate to do so.

7.3 It is essential that the OTC derivatives markets are able to continue to provide fully tailored solutions to market participants on economic terms, to enable their often very specific risks to be fully mitigated—imperfectly managed risks on a broad scale could have unwelcome longer-term economic implications.

TRADE REPOSITORIES

Central data repositories provide aggregate information of firms' positions and improve operational efficiency of Over The Counter (OTC) derivatives markets and market transparency. The communications suggest that legislation should provide a common legal framework for the operation of trade repositories. The Commission believe the European Securities and Markets Authority (ESMA) should be responsible for authorising and supervising trade repositories.

8. *What benefits does the use of trade repositories bring both in terms of transparency and improved risk management?*

8.1 In terms of transparency, a single global trade repository (TR) per asset class could provide regulators globally with position and transaction-based information (centrally and bilaterally cleared contracts) to assist in their supervision of firms, both at a macro and micro-level. However, if TRs only cover OTC derivatives, while they would provide an enhanced level of transparency, it would nevertheless be an incomplete view of the firm/industry risk, as the underlying positions being hedged would not be included.

8.2 TRs are no substitute for firms maintaining a robust risk management process and appropriate regulatory oversight of firms' risk management mechanisms.

8.3 TRs could also be utilised to enhance post-trade transparency in the OTC derivatives markets through the provision of aggregated, anonymised end-of-day information. We would caution against TRs being used to provide any full and immediate post-trade transparency at market participant level as this would poorly serve these professional markets, as the benefits arising from such a move would be more than outweighed by the negative impact on liquidity.

8.4 A number of global industry lead initiatives are already underway in relation to TRs and it is important that TRs are developed bearing in mind the specific nature of the asset class concerned and that duplication (such as that potentially with transaction reporting and the Transaction Reporting Mechanism) are avoided.

9. *Should the EU regulate the legal framework for the operation of trade repositories?*

9.1 As reflected in our response to question 4 above in relation to CCPs, given the global nature of the OTC derivatives markets, and in particular our view that a separate single global TR should be developed for each asset class, we believe harmonised global regulatory standards should be developed for TRs and we welcome regulatory oversight which supports this approach.

10. *What provisions and rules should such regulation impose to improve regulation of trade repositories?*

10.1 We believe a principles-based regulatory regime for TRs based on global standards, tailored to meet the different characteristics of each asset class, should provide for:

- adequate information security and confidentiality protections;
- appropriate access rights to regulators globally, based on supervisory need and their responsibility;
- business continuity plans to address legitimate legal concerns, including confidentiality; and
- data submission criteria and protocols.

11. *Should trade repositories be supervised by ESMA or by national supervisory authorities?*

11.1 With respect to the issue of whether supervision of TRs should operate at a national or EU level, as with CCPs, we would recommend that sufficient time be given to determining whether similar proposals for the regulation of Credit Rating Agencies are effective, particularly at promoting global standards, before further steps are taken with regards to TRs.

FURTHER ISSUES

12. *The Commission intends to review the Market Abuse Directive and may extend its scope to capture more OTC derivatives and give regulators the power to set position limits. Will this improve the integrity of derivatives markets as intended?*

12.1 The Market Abuse Directive (MAD) currently covers Credit Default Swaps and Equity Derivatives where the reference security is admitted to trading on a regulated market. We would welcome proposals to extend the scope of the MAD beyond its current limits as, in our view, the same market cleanliness standards should prevail whether a counterparty is transacting a CDS contract or, for example an Interest Rate or Commodity contract.

12.2 However, given the tools available to regulators and exchanges, including the likely widening of the scope of the MAD, we do not support the setting of position limits.

12.3 Firstly, most EU exchanges already have in place the necessary discretion to take action against holders of dominant positions. For example, the London Metal Exchange ensures there is sufficient liquidity in the market by enforcing lending guidance when the position of a party or parties acting together reach certain thresholds. The existence and use of these powers help to mitigate against the build up of abusive positions.

12.4 Secondly, provisions exist specifically within the MAD which enable action to be taken by regulators against market participants where they have affected a market squeeze or otherwise manipulated the market. We are unsure of the specific market failure which position limits are expected to address and believe, moreover, that setting such arbitrary limits will likely reduce market liquidity and hinder price discovery which would be to the detriment of the broader market and its users.

13. *The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect, of increasing stability?*

13.1 While we understand the Commission's perspective on the importance of adequate collateralisation, we would caution against measures which require financial firms to post initial and variation margin on all bilaterally settled contracts or proposals which require margin from non-financial firms. Given the diverse nature of market participants' creditworthiness, we believe financial firms should be left to decide the appropriate level of collateral that is required, rather than be subject to rigidly imposed collateral requirements. We believe it would be more appropriate and effective from a financial stability perspective for supervisors to test the adequacy of firms' risk management processes, including collateralisation, and seek improvements where they are found to be deficient.

13.2 For your reference, for bilaterally cleared contracts, J.P. Morgan aims to collateralise all counterparty credit exposure wherever possible using bilateral Credit Support Annexes (CSAs). We aim for daily valuation frequency, appropriate thresholds and minimum transfer amounts based on our internal credit view of the counterparty and, where appropriate, J.P. Morgan will also take upfront margin, where the amount taken will be determined at our discretion and will be based on the perceived level of risk on the contract and market participant and stage within the credit cycle. Any unsecured or residual exposure will be captured in our credit risk exposure metrics and will be a factor in both credit decisioning (ie when determining credit appetite to a market participant or contract and setting appropriate risk limits) and the calculation of credit risk regulatory capital. We would discourage any measures which prohibit firms from extending credit, including on an unsecured basis, as long as the decision is based on sound risk management practices.

14. *Are current EU regulatory plans regarding derivatives markets sufficiently harmonised with US and global regulatory plans to avoid regulatory arbitrage or business migration?*

14.1 We understand there is a robust dialogue taking place between the US and EU regulators on derivatives and we welcome moves which maximise harmonisation between the two regimes. Without this, we believe there is a risk of regulatory arbitrage and outcomes which are sub-optimal in terms of global market stability and efficiency.

14.2 As a leading global participant, we have worked alongside other major OTC derivative dealers, and have made a number of commitments to regulators, including to: clear standardised OTC derivatives contracts; deliver robust collateral and margining processes; implement central data repositories for non-cleared contracts; enable customer access to clearing; update industry governance to be more inclusive of buy-side

participants; and continue to drive improvement in industry infrastructure. We look forward to continuing to work with EU and US regulators to order to strengthen the framework of the OTC derivatives market.

14.3 We welcome the formation in September 2009 of the OTC Regulators' Forum as we envision this will help drive the development of further global standards and approaches.

15. *Are there further areas for regulation that the communications do not cover?*

15.1 No.

1 February 2010

Letter from Managed Funds Association

Managed Funds Association ("MFA")¹⁴ welcomes the opportunity to provide comments in response to the House Of Lords, EU Sub-Committee A's call for evidence (the "Call for Evidence") regarding the European Commission's communications on ensuring safe and sound derivatives markets (the "Communications"). MFA applauds the House Of Lords' efforts to develop proposals to reform the supervision of the over-the-counter ("OTC") derivatives markets in the European Union through an informed and deliberative consultation process.

These issues are of significant importance to MFA members because hedge funds are active participants in the OTC derivatives markets and have a strong interest in promoting the integrity and proper functioning of these markets. Because OTC derivatives provide significant benefits to various market participants by allowing them to manage risks associated with their business activities or their financial assets, MFA believes that these markets are essential to the restoration of capital flows within the global economy.

For your convenience, we have included the questions from the Call for Evidence in this response letter. The questions are in the order presented in the Call for Evidence and are in italics, with MFA's response included below each question.

1. *What economic benefits do derivatives bring?*

As mentioned above, MFA believes that OTC derivatives play a critical role in our global capital markets by enabling businesses, financial institutions, governments and institutional investors to effectively manage various risks associated with their business activities or financial assets. For example, market participants use derivatives contracts to hedge against market risks (*eg*, events such as bankruptcy, fluctuations in the relative value of foreign currencies, or for companies that issue debt to fund their growth, changing interest rates) and counterparty risks (*ie*, default exposure to a trading counterparty). OTC derivatives perform these functions better than other risk management tools because they are liquid with low transaction costs, have substantial depth of market, and are more readily accessible as compared with other financial products.

The importance of the OTC derivatives market is further demonstrated by the various types of financial institutions, non-financial institutions and other market participants, which use them. For example, the International Swaps and Derivatives Association ("ISDA") has recently published data showing that OTC derivatives are used by a vast number of the world's largest companies to manage various risks that arise in connection with their businesses.¹⁵ ISDA's survey reveals that these companies have found OTC derivatives to be essential to their day-to-day operations by helping insulate them from various market and counterparty risks.

In addition, OTC derivatives markets also provide significant benefits to the global economy by providing liquidity for capital markets. For instance, banks and other financial institutions have been able to engage in increased lending and corporate finance activities as a result of their ability to trade CDS, which provides them with a mechanism through which they can transfer credit risks to other market participants, which are willing to accept that risk. Ultimately, increased lending and credit flows result in: (i) lowered costs of borrowing for many big and small businesses all around the world; and (ii) greater access for consumers to credit to purchase necessary goods and services.

¹⁴ MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, DC, with an office in New York.

¹⁵ ISDA published results of a survey it conducted on derivatives usage by the world's 500 largest companies (April 23, 2009). A press statement regarding the survey is available at: www.isda.org. See our response to question 7 below, which further discusses our position with respect to collateral management practices and AIG's role in the financial crisis of 2008.

2. What risks are associated with derivatives and derivatives markets?

There are three primary types of risk associated with, but that are not unique to, OTC derivatives and OTC derivatives markets: (1) operational risk; (2) counterparty default risk; (3) and systemic risk. Operational risk is the potential for losses that could occur from human errors or failures of systems or controls. Over the last five years, market participants and financial regulators have taken steps to help mitigate operational risks and challenges related to OTC derivatives trading activities, with a particular focus on the market's infrastructure. Market participants and financial regulators have collaborated to eliminate large backlogs of unconfirmed derivatives, to publish standardized contract terms for OTC derivatives, and to develop improved processes and procedures for the physical settlement of underlying assets, novation of derivatives positions from one counterparty to another, and procedures for addressing valuation disputes.

Counterparty default risk is the risk that a derivatives counterparty will be unable to meet its contractual obligations under a derivatives contract. In addition to potentially not receiving contractual payments, a derivatives counterparty whose counterparty defaults could suddenly be left without protection of the derivatives contract and could either have to replace the contract at current, higher market values or go without protection. Dealers, large buy-side firms and some other market participants that have large derivatives exposures currently use a variety of techniques to limit, forecast, and manage their counterparty risk, including the posting of mark-to-market margin (commonly known as variation margin) and upfront margin (commonly known as initial margin). For example, hedge funds generally post both initial margin and variation margin to their dealer counterparties in connection with their derivatives positions. As a general matter, this practice makes hedge funds less risky in comparison with derivatives counterparties that do not post margin or provide other protections (*eg*, AIG).

Systemic risk is the aggregation or interconnectedness of counterparty default risks faced by individual firms, which may ultimately effect the entire financial system. It is our view that the possibility of widespread default throughout the financial system caused by derivatives alone is exaggerated, principally due to the low default risk associated with individual derivative contracts. Recognizing the threat that OTC derivatives could pose to the financial system, regulators and market participants have initiated several efforts to address certain risks posed by these financial products, including the standardization of many OTC derivative products, the establishment and implementation of industry-wide protocols, and the multilateral netting of large derivatives portfolios, which reduces the number of trades outstanding between market participants without affecting each participant's risk profile.¹⁶

In addition to the above-described primary risks, regulators and some observers have cited the lack of transparency or disclosure in the OTC derivatives market as a major concern. While MFA strongly supports increasing market transparency, we believe that the lack of transparency or disclosure may have compounded systemic risk concerns and overall market uncertainty regarding market concentration of exposures and the worldwide gross notional and total net exposure of OTC derivatives contracts.

There are several market initiatives underway to increase transparency and disclosure of OTC derivatives contracts. Pricing, trading volumes and aggregate open interests are currently available on most credit derivatives contracts through databases operated by privately-owned service providers. For instance, Markit[®], an industry pricing service, currently provides end-of-day pricing on over 3,000 issuers through daily polling of approximately 100 contributing parties.¹⁷ In addition, as is discussed in our response to question 6 below, market participants have increased the use of trade repositories as a means to disclose their positions.

Notwithstanding these market initiatives, MFA is fully supportive of the regulatory reform efforts in the United States to oversee the derivatives markets and derivatives dealers. The legislative proposals that are now before U.S. Congress seek to: (1) reduce risk through the use of CCPs, while respecting the importance of customized derivatives contracts; (2) require segregation of customer collateral at the request of a customer; (3) increase regulatory transparency through trade reporting; and (4) provide the government with additional authority to avert and respond to economic or financial turmoil without disrupting the ordinary operation of

¹⁶ Examples of these efforts include, without limitation: (1) dealer clearing started in Europe in July 2009; (2) the reduction by 92% of backlogs of outstanding CDS confirmations since 2005; (3) the establishment of electronic processes to approve and confirm CDS novations; (4) the establishment of an auction hardwiring completed April 8, 2009, to allow for auction-based settlement of CDS (called the "Big Bang Protocol"); (5) the roll out of a restructuring credit event protocol (also known as the "Small Bang Protocol") to further standardize CDS contracts for centralized clearing; and (6) several non-dealer firms began clearing their CDS transactions on certain CCPs on December 15, 2009.

Many of these initiatives have taken place under the auspices of the Senior Supervisors Group, which is comprised of senior financial supervisors from seven countries including regulators in Europe and the United States. More information on their efforts can be found on the U.K. Financial Services Authority Web site at:

http://www.fsa.gov.uk/Pages/Library/Other_publications/Miscellaneous/2009/index.shtml

¹⁷ More information on Markit's pricing data is available at: <http://www.markit.com/en/products/data/cdspricing/cdspricing.page>.

the markets). We believe the passage of the derivatives legislation ultimately will improve market efficiency, reduce counterparty risk and systemic risk, and help regulators identify cases of market manipulation, insider trading or other abuses.

3. *What role did derivatives play in the recent financial crisis?*

In the wake of the most recent financial crisis, some market observers have cited OTC derivatives as one of the primary causes of the crisis. Many regulatory bodies and industry observers have stated, however, that derivatives were not a central cause of the crisis.¹⁸ We agree with these regulatory bodies and observers and believe that that excessive risk-taking in the housing industry, excessive use of leverage, and over-reliance on credit ratings were integral parts of the financial crisis of 2008 and 2009.

In contrast, OTC derivatives helped market participants to hedge their risk exposures during the worst months of the financial crisis. It is arguable that OTC derivatives helped market participants to prevent further losses during that time. For example, the CDS market was essential for managing risk in connection with more than 53 global corporate defaults (including Lehman Brothers) in 2008 and 2009.¹⁹

4. *What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?*

MFA has a strong interest in ensuring that any regulatory reform in the European Union addresses counterparty risk and systemic risk. We strongly support the clearing of “clearable” or “standardised” derivatives on CCPs based in Europe and the United States. We also support competition among CCPs and believe that derivatives regulation should not force segmentation of the market based on jurisdiction.²⁰ We believe, however, that EU regulation should impose three rules on central counterparties (“CCPs”) to reduce these risks: (1) protection of customer positions and collateral (specifically, initial margin); (2) open access and membership for end users, including hedge funds; and (3) appropriate resources and infrastructure to prevent CCP failure.

MFA believes that the protection of customer positions and collateral in a central clearing regime is absolutely critical to the success of central clearing initiatives and the reduction of counterparty risk and systemic risk. MFA urges the European Commission to impose rules that would require: swap dealers and CCPs to segregate initial margin in accounts that are separate and apart from the assets of the swap dealer; and CCPs to move customer positions in the event of the insolvency of a clearing member. In our view, these rules would greatly reduce counterparty and systemic risk associated with the trading of OTC derivatives in the event of clearing member insolvency.

Lehman Brothers’ failure demonstrates the reasons why a rule requiring segregation of customer collateral would reduce these risks. In our view, a requirement to segregate customer collateral would have helped to lessen the rippling effects of the Lehman Brothers’ bankruptcy. As a regular practice, Lehman Brothers and other swap dealers did not segregate customer collateral. Instead, they used it as an inexpensive source of financing. After Lehman Brothers’ bankruptcy, their failure to segregate customer collateral raised concerns regarding the viability of those other dealers. These concerns eventually weakened market stability as market participants acted quickly to protect their assets from further counterparty exposure. Ultimately, this practice exacerbated systemic risk to global capital markets by increasing counterparty risk.

In addition, MFA believes that the European Commission should impose rules that broadly encourage central clearing by allowing end-users (including hedge funds) to have fair and open access to central clearing either through direct participation in a CCP as a clearing member, or through a clearing member. In addition, we believe that CCP governance arrangements should be transparent and take into account the views of all market participants. In our view, these measures will encourage end users to centrally clear their derivatives contracts, which will in turn reduce the interconnectedness that results from too much credit exposure flowing through a limited number of dealers.

Finally, we believe the European Commission should impose rules requiring CCPs to have appropriate financial resources and risk management practices to minimize risk of CCP failure. By definition, CCPs are systemically significant entities, and therefore, it is essential that the European Commission impose rules to ensure the viability and proper functioning of CCPs that operate in Europe.

¹⁸ As referenced above in footnote 4, the Senior Supervisors Group noted that “the industry’s substantial efforts to standardize practices and reduce backlogs of unconfirmed over-the-counter derivatives positions appear to have significantly mitigated a substantial systemic risk.” See “*Risk Management Lessons from the Global Banking Crisis of 2008*” (21 October 2009), which is available at: www.sec.gov/news/press/2009/report102109.pdf.

¹⁹ For more information regarding the number of credit events and auctions, please visit www.isda.org.

²⁰ We do not believe it is appropriate to place jurisdictional-based requirements on central clearing. See our response to question 9 below, which sets out our position regarding the European Commission’s proposal requiring market participants to use a European-based CCP to clear CDS on European-reference entities and indices.

5. *Should higher capital charges be applied to trades not centrally cleared and to non-standardised derivative contracts?*

We believe that it is appropriate for regulators to impose higher capital charges on trades that are eligible for central clearing, but that are not centrally cleared. Imposing higher capital charges in this instance would create a strong incentive for market participants to centrally clear OTC derivatives where it is possible for those derivatives to be cleared through a CCP.

In contrast, MFA believes that it is critical to provide market participants with the ability to engage in non-standardised or customized derivatives without imposing overly burdensome capital charges. Non-standardised derivatives allow market participants to custom manage their firm or company's specific risks in a way unmatched by standardized derivatives. Instead, MFA believes that the European Commission should work with market participants to increase the number of standardised derivatives eligible for central clearing and require the imposition of appropriate levels of margin in connection with the trading of non-standardised derivatives.

6. *What benefits [do] the use of trade repositories bring both in terms of transparency and improved risk management?*

As mentioned above, MFA strongly supports the use of trade repositories to record non-cleared OTC derivatives contracts. We believe that trade repositories will enhance market transparency for regulators and will reduce systemic risk by ensuring that regulators have a comprehensive picture of market concentrations and exposures within a given asset class. In addition, a trade repository may also provide operational benefits for market participants by helping to facilitate central clearing and by reducing the notional amount of trades through trade portfolio compression.

7. *The Commission intends to tackle low collateral levels it argues are often present in products cleared bilaterally. Will this approach bring about the desired effect of increasing stability?*

We believe that the European Commission's approach to monitor and, when appropriate, to impose minimum collateral levels with respect to non-cleared derivatives transactions is the correct approach. It is our view that industry-wide collateral practices were inadequate prior to the near-failure of AIG. As referenced above in our response to question 2, AIG was able to take very concentrated derivatives positions without having to post any collateral in connection with those positions. The financial crisis arguably would not have been as acute, if all or a majority of derivatives market participants were required to post appropriate levels of collateral. We believe ultimately that increased oversight of market participants with highly concentrated positions will help increase market stability.

8. *The [European] Commission intends to review the Market Abuse Directive and may extend its scope to capture more OTC derivatives and give regulators the power to set position limits. Will this improve the integrity of derivatives markets as intended?*

MFA does not believe that providing regulators with the authority to set position limits will improve the integrity of derivatives markets. Position limits do not address market integrity or systemic risk concerns, which can be addressed through appropriate capital and margin charges, disclosure requirements, and other regulatory measures. As a general matter, MFA believes that position limits should be imposed only for physically-delivered commodities and where the deliverable supply of the commodity is limited and, thus, susceptible to control and manipulation.²¹

9. *Are current EU regulatory plans regarding derivatives markets sufficiently harmonized with U.S. and global regulatory plans to avoid regulatory arbitrage or business migration?*

Although many of the details of the regulatory proposals in the European Union, the United States and other countries remain uncertain, we believe that these proposals share the same policy objectives: mandatory central clearing, increased reporting to trade repositories, greater transparency, etc. In light of the global nature of the OTC derivatives markets, MFA believes that coordinated international regulation will permit greater market efficiencies and prevent market segmentation. MFA strongly encourages the European Commission to coordinate its regulation and oversight of the OTC derivatives markets with other regulators around the world.

²¹ MFA does not take a position with respect of whether broadening the scope of the Market Abuse Directive to include OTC derivatives will improve market integrity.

On 4 September 2009, MFA submitted comments to the Committee of European Securities Regulators (“CESR”) on, among other things, the issue of regulatory harmonization of the derivatives market in response to CESR’s call for evidence on mutual recognition with non-EU jurisdictions.²² In our letter, we expressed our concerns with the European Commission’s requirement that market participants must use a European-based CCP to clear CDS on European-reference entities and indices. In our view, this requirement would frustrate the establishment of a globally harmonized regulatory framework for derivatives and lead to an unfair playing field for European-based CCPs.

In contrast, and as noted above, we support the legislative proposals under consideration in the U.S. Congress to regulate the derivatives markets and derivatives dealers, although many of the details of these proposals remain uncertain. In particular, we believe that the provisions in these proposals that encourage international coordination, permit non-U.S. market participants to register with U.S. regulators, and reduce risks to the global financial system, are consistent with the global harmonization of regulation over the OTC derivatives markets.

10. *Are there further areas for regulation that the communications do not cover?*

For all of the same reasons cited in response to question 4 above with respect to collateral segregation for *cleared derivatives*, MFA believes that regulation that would require dealers to offer their customers the availability of collateral segregation in *bilateral, non-cleared derivatives transactions* is necessary. We believe that the benefit that the financial system will derive from the mandatory clearing of standardised derivatives will be substantially multiplied if consistent protections are at least made available with respect to non-cleared derivatives.

CONCLUSION

Again, MFA appreciates the opportunity to provide comments in response to the Call for Evidence regarding the Communications. MFA supports efforts to create more efficient OTC derivatives markets, reduce risks, promote investor protection, and protect the stability of the global financial system. We are committed to being constructive participants in the regulatory reform discussions in the European Union and to working with the European Commission to reestablish a sound financial system and restore stable and orderly markets.

1 February 2010

Memorandum by MarketAxess

1. MarketAxess operates a leading electronic trading platform for US and European high-grade corporate bonds, emerging markets bonds and other types of fixed-income instruments, including credit default swaps. MarketAxess is a public company (Nasdaq: MKTX), and our principal US subsidiary, MarketAxess Corporation, is regulated as a broker-dealer and alternative trading system operator by the SEC and FINRA. Our UK subsidiary, MarketAxess Europe Limited, is regulated by the FSA as a Multilateral Trading Facility. Our clients include approximately 700 active institutional investor clients (investment advisers, mutual funds, insurance companies, public and private pension funds, bank portfolios and hedge funds) and 67 broker-dealer clients located in the United States and Europe.

2. MarketAxess has been committed to bringing the benefits of electronic trading to participants in the fixed-income markets since the company’s inception in 2000. Foremost among these benefits are efficient access to markets and information (we provided corporate bond data to our clients even before the 2002 introduction of TRACE, and we were an early promoter/distributor of TRACE market data); the reduction of investors’ transaction costs through the promotion of price competition among fixed-income dealers; enhanced ability to confirm “best execution” through the provision of electronic audit trails and other automated compliance tools; and the virtual elimination of trade errors through straight-through processing.

3. We have read with great interest the European Commission’s communications on ensuring efficient, safe and sound derivatives markets, and we agree that many benefits will accrue to the OTC derivative markets and the economy from a sound regulatory environment, electronic trading and central clearing. We are concerned, however, that the communications may not adequately credit the services that MarketAxess’ regulated, transparent electronic trading system is currently providing to fixed-income market participants and the important role that we can play in helping legislators and regulators to achieve the regulatory reform objectives set forth in the communications.

²² A copy of MFA’s letter is available at:

<http://www.managedfunds.org/downloads/MFA%20comments%20on%20CESR%20Letter%20Mutual%20Recognition.pdf>

4. We are strong believers in the fundamental benefits that derivatives provide to our capital markets. Exchange-traded futures, interest rate and credit default swaps, and foreign exchange derivatives all make a meaningful contribution to the efficient flow of capital. Without these derivative markets, borrowing costs would be higher, the ability to transfer risk would be limited and the resultant adverse effect on the availability of credit means that jobs would be lost.

5. We believe that many of the regulatory tools available in exchange-traded futures markets could provide real benefits to the over-the-counter derivative markets. The move toward central clearing for standardized derivatives, in conjunction with sensible initial and maintenance margins, will greatly reduce counterparty risk in credit default swaps and ensure that adequate capital underpins the amount of risk in open positions. Similarly, price transparency at the time of execution will increase market fairness, participation and risk awareness. Electronic trading will reduce trading and processing errors, reduce transaction costs and provide valuable real-time supervisory tools for large transaction reporting.

6. In sum, we are strong believers in real-time market transparency, electronic trading and central clearing. We believe that extending these enhancements to over-the-counter derivative markets will greatly increase participation and efficiency in the marketplace.

We have recently had the opportunity to discuss these issues, and to demonstrate the functions and capabilities of our trading platforms, to Chairman Gary Gensler of the US Commodity Futures Trading Commission and several members of the Financial Services Committee of the US House of Representatives, as well as to staff members of the SEC and the Federal Reserve Bank of New York. We would welcome the opportunity to do the same for you and/or your staff, at your convenience.

7. Thank you for your consideration of our views on this important matter.

REFERENCE

- ⁱ The Trade Reporting and Compliance Engine (TRACE) is the FINRA-developed vehicle that facilitates the mandatory reporting of over-the-counter secondary market transactions in eligible fixed-income securities. All broker-dealers that are FINRA member firms have an obligation to report transactions in corporate bonds to TRACE under an SEC-approved set of rules.

February 2010

Letter from Dr Chiara Oldani, University of Viterbo, Italy

QUESTIONS ANSWERED

DERIVATIVES

What economic benefits do derivatives bring? What risks are associated with derivatives and derivatives markets? What role did derivatives play in the recent financial crisis?

CLEARING DIRECTIVE

The Commission intends to produce legislation regulating the activities of central counterparties (CCPs) with the objective of eliminating national regulatory discrepancies, improving risk management and creating a single European market for CCPs. Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring? What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets? Should higher capital charges be applied to trades not centrally cleared and to non-standardized derivative contracts?

ANSWER

The analysis of the contribution of derivatives to financial markets by the EU should start from addressing the lack of data about the phenomenon. The lack of data lasts from the beginning of the market's settlements and has been justified by the fact that trading takes place mainly Over The Counter, and involves only professional operators. Only intermediaries in the market know the resources involved, and the risks connected. Nevertheless, the interconnection of risks, and potential losses are not known, diminishing the strength of the financial system.

The Bank of International Settlement is the only institution that considers the systemic role derivatives play, in its Triennial Report. The very low frequency of these data, and the absence of any breakdown of data, especially for non-financial operators (non financial firms, governments) make any macroeconomic analysis and investigation not very robust.

The informative advantage intermediaries have, especially in OTC transactions, is no longer justified, since the public interest should prevail over private gain.

The lack of data together with insufficient capitalisation of opaque intermediaries (eg Bear Sterns) has damaged the entire financial system in the recent credit crisis, underlying the need for reforms that cannot be procrastinated any more.

The economic and statistical results available in the literature (eg on the Journal of futures markets) refer to exchange traded contracts and counterparts (basically financial intermediaries) while OTC transactions and non-financial intermediaries are not under intense scrutiny. This means that 2/3 of global derivatives' market (according to the BIS Quarterly Review data) is not appropriately monitored and that the available results are valid only for a relatively small share of global transactions and wealth.

The economic analysis of derivatives (on exchange traded transactions) has so far underlined some benefits of financial derivatives; they are considered to ameliorate financial markets, and in particular they increase pricing efficiency (ie lower the bid ask spread), reduce markets' noise and improve liquidity of the underlying assets' markets.

Most operators and analysts argue that since pricing rules for exchange-traded and OTC contracts are the same, benefits of exchange-traded contracts should be valid also for OTC. This approach is wrong for a number of reasons, since OTC contracts are of different nature, are far bigger (in terms of notional value) and play a different role in portfolios (ie manage risks which are not standardized and over different time horizon).

Risks associated with exchange-traded derivatives are those coming from the underlying asset, and combine with each other forming non-linear causal relationships. Markets rules address these risks, while monitoring and supervision should cope with the evolving behavior of the market.

On the other side, OTC contracts are wide spread among professional operators, can satisfy the complex needs of the financial system, and represent a large share of global financial wealth.

OTC contracts are opaque, and tailored on customers needs, producing a non-zero counterparty risk. This risk is decreased by introducing a CCP or by introducing certain requirements for financial operators underwriting these contracts, for example in terms of capital. In case the CCP is introduced, it should be at a European level (not national), with a high level of coordination with other countries-areas (USA, Canada, Japan) and in cooperation with International Financial Institutions (IFIs).

During the presents financial crisis OTC derivatives acted like the turbo in the car's engine: they let the virus spread faster. The subprime credit has been the source of the disaster, and the Basle II system has been the only way for Europe to cope with the enormous financial risks created with deregulated financial securities. The resilience of the European banking system is the indirect proof. Basle II has a certain degree of procyclicality but up to the present the advantages produced by the European resilience far exceed the costs, after considering massive Governments interventions.

The lack of adequate capitalization for a number of non EU financial intermediaries let the risks to spread, without any form of compensation. Capital charge should be imposed to all intermediaries entering the financial system (regardless of their headquarter), and higher capital charges should be applied to trades not centrally cleared and to non- standardized derivative contracts, in order to decrease excessive counterparty risks.

USEFUL REFERENCE

Chiara Oldani, *Governing Global Derivatives*, Ashgate Pub. Nov 2008.

3 February 2010

Letter from Mr Antonio Sáinz de Vicuña

Thank you for the opportunity to respond to your consultation. I apologise for the late reply.

I should stress that what I have to say are my private views and should in no way be construed/treated/be attributed to the ECB. The ECB will adopt an opinion on any eventual legislative proposals of the Commission, and therefore it is only for the Governing Council of the ECB to express an institutional Eurosystem view. I will limit myself to addressing legal issues and in interest of brevity under the heading of the main topics and not question by question.

1. CLEARING DIRECTIVE

I believe a legally binding framework for central counter party (CCP) clearing at EU level would benefit the whole of the derivatives markets. CCPs improve the transparency and risk control of OTC derivatives, and introducing EU wide legislation benefits the dimension of the derivatives market. An EU Clearing Directive would be a useful step towards the establishment of a single market for clearing and settlement. Having said that, to achieve its full potential a set of highly harmonised rules and preferably a single rulebook is required.

As regards the provisions of a possible EU directive, it would be an opportunity to transpose into law the CESR-ECB Recommendations on Securities Settlement Systems and on Central Counterparties, adopted in May 2009²³—which was a significant step toward promoting soundness of centrally cleared derivative transactions. Specifically, I expect the directive to include rules on governance, participation requirements (strict),²⁴ and transparency (eg of decision making and pricing). The capital charges rules should incentivise CCP clearing by being proportional to the level of risk, which is higher in OTC derivatives—if not centrally cleared these transactions require more attention to be paid to risk controls such as collateral and capital requirements. There should also be strict requirements on participants to segregate clients' assets.²⁵ As regards making the clearing of standard derivatives transactions through CCPs mandatory, this requires careful consideration. CCPs should in view of the risks they run have some say in which type of standardised derivatives they will accept, but in principle the scope of product types should be as wide as possible and all MiFID asset classes should be eligible.

This initiative should be combined with cooperation with the US and other non EU jurisdictions in view of the global nature of today's derivatives market. I note that US is considering to move standardised derivatives products to transparent trading venues and regulated clearing houses.

2. TRADE REPOSITORY DIRECTIVE

Trade repositories are an essential tool to enhance transparency, which in turn facilitates better calibration of risks. There should be a duty on participants to report all types of derivatives whether OTC or traded on a regulated market as they provide vital information to assess levels of exposure. Secondly, the EU approach of harmonising the function and allowing for EU-wide operation would permit operators of repositories to market themselves more effectively throughout the EU than if the regulations remained at national level.

I would not see ESMA becoming a proper EU supervisor (ie a European Supervisory Authority), before the time where there is a single set of rules that a EU supervisor may apply, which does not yet exist in this area. ESMA is to be only a European agency with regulated functions *vis-à-vis* national supervisors, which may play a useful role to standardise approaches and practices, and coordinate supervision.

May I add finally that I was very pleased to appear last year before your select committee, whose work I greatly appreciate. It therefore gives me continued pleasure to be able to assist its work.

8 February 2010

Memorandum by Wholesale Market Brokers Association (WMBA) and the London Energy Brokers Association (LEBA)

1. INTRODUCTION

1.1 The Wholesale Market Brokers' Association ("WMBA") and the London Energy Brokers Association ("LEBA") are the European industry association for the Interdealer Brokers ("IDBs") in the Over-the-Counter ("OTC") financial, energy/commodity, equity, credit, cash and derivatives products. Together the associations have eighteen members comprising the entirety of the IDB sector, which are listed in appendix three (www.wmba.org.uk and www.leba.org.uk). WMBA and LEBA members are limited activity firms that act as intermediaries in wholesale financial markets, with a principal client base made up of global banks, primary dealers, leading regional banks, asset managers, oil companies, energy generators and transmission operators.

²³ http://www.ecb.europa.eu/press/pr/date/2009/html/pr090623_escb-cesr_recommendations.pdf. The draft recommendations, published on 23 June 2009, had been reviewed in mid 2008 at the request of ECOFIN specifically to reflect risks in OTC derivatives markets and the role of CCP clearing in the mitigation of the risks.

²⁴ See Recommendation n 2 for CCPs in the CESR-ECB Recommendations referred to in footnote 1. The "fit and proper" test should be strictly supervised.

²⁵ See ECB opinion of 13 September 2009 on the Commission Communication on enhancing resilience in the OTC derivatives market, esp para 5, page 2.

Replies to the consultation paper should be seen in the context of member firms acting exclusively as intermediaries, and not as own account traders. For this reason some of the questions in this Consultation Paper are not entirely relevant to WMBA/LEBA member firms activities, although they are to most of their clients, and some answers take into account industry views and experience.

1.2 In drafting this response, WMBA/LEBA has maintained its usual cooperation with the Futures & Options Association (“FOA”), the International Swaps and Derivatives Association (“ISDA”), the Foreign Exchange Joint Standing Committee on the Bank of England and the City Corporation of London. We acknowledge that these entities are submitting their own responses to the Sub Committee Call for Evidence and in order not to duplicate comment we endorse and support most of those submissions in addition to the comments made herein.

1.3 WMBA/LEBA supports the EU Commission’s objective to ensure “efficient, safe, and sound derivatives markets” and appreciate the recognition in the report that derivatives are important tools for risk mitigation and transfer and that overall they benefit the global economy. We would however ask the Committee to recognise the differences between OTC Products in general and Derivative Products in specific, since whilst they often overlap, they are not fungible. This concept will be expanded upon in our response.

1.4 We disagree with the assertions recently from both Chairman Gensler and the EU Commission that the “Derivatives Markets” have been at the centre of the financial crisis. Whilst Mortgage Lending and Packaging, other Structured Products, Audit Procedures, Credit Ratings and the behaviour of Credit Agencies were all fundamental the financial crisis, the OTC and Derivatives Markets themselves were the bedrock of the continuing functioning of the financial markets and, indeed, without the ongoing operations of the OTC and Derivatives Markets the financial crisis would have been more severe and even more far-reaching. The Corporation of London Paper of 10 June 2009 on the relationship of OTC Derivatives to the Financial Crisis explains this fully.

1.5 We would respectfully ask the regulators and those drafting policy against issuing any legislation that adds further “Incentives” or “Penalties” into the use of derivatives markets. The incentives to promote more transparently transacted products, to adopt automated post-trade processes and to employ central clearing are already strong, clear and present. Any moves towards penalising market participants and end users for not embracing risk mitigation and control processes could lead to the substitution of settlement risk with basis risk (ie a mismatch between exposure and protection) and would therefore be inherently detrimental.

1.6 Legislation involving mandated “Product Standardisation” would be at best unhelpful. Obfuscation exists between Legal Standardisation, Product Standardisation & Process Standardisation. ISDA has made great progress in legal uniformity and process uniformity in recent years and this trend needs encouragement. An insistence on Product Standardisation in any form would decrease market liquidity, increase gross market risk for all participants and enlarge total net costs for end users.

1.7 We would emphasise that the notion of Standardisation has little or no correlation to Clearing. The creation of valid initial margins combined with the daily calculation of correct variation margins is the prerequisite for the operation of a Central Counterparty (“CCP”). Clearly, this process applies to complex or bespoke products as long as reliable margins may be calculated and agreed with clearing firms. However, the responsibility for the introduction of these margin requirements must rest with the Risk Committee and management of a CCP. Indeed, the utility of a CCP can only be determined on a trade-by-trade basis by the behaviour of end-users (ie clients of the clearing firm) involved—if there is not a demonstrable net benefit in terms of not just cost but also in front, middle and back office operations and the ability to communicate with customers the CCP offering will not have staying power. We would stress the requirement for equal and open access, both commercially and technologically, to clearing on a trade-date basis for all market participants and note with approval the emphasis regulators around the world have recently placed upon the unbundling of Execution and Clearing.

1.8 We remain concerned that many who are involved in drafting policy around the world currently that is intended to further regulate derivatives, are paying insufficient regard to the mechanics of Price Formation in Derivative Markets by the implicit unfavourable comparison of voice brokered price matching against continuously quoted, electronically matched markets. Publicly available data confirms that purely exchange traded products experienced a notable decrease in volume in “Benchmark” or “Plain Vanilla” products during the recent extreme market volatility as the price discovery and counterparty protection provided by voice brokers became more crucial in keeping the markets functioning. This volume transfer from exchange traded, fully electronic volumes to the volume sphere was one of the most meaningful events of the financial crisis and, while temporary, will have a lasting impact on the structure and behaviour of the OTC and Derivative marketplaces. Efficient risk transfer and the automation of the post trade confirmation, affirmation and clearing remain critical, and recent experience has confirmed that these facilities are independent of the means

of execution, ie that voice, voice assisted or fully electronic IDB OTC transactions follow the identical post-trade path as do exchange traded products. We stress that whichever way prices are formed, the post-trade automation and transparency remains uniform. Paramount here is the market demand for flexible voice brokerage in periods of crisis and market stress has never been higher and therefore the IDB community wishes to call attention to our role in mitigating risk and our commitment to continue to participate with authorities to implement practical solutions for our mutual constituents.

1.9 WMBA/LEBA endorses not only MiFID, but also the Bank of England's Non-Investment Products ("NIPs") Code and Market Abuse Directives. Competition is embedded into MiFID, ensuring end user efficacy. We repeatedly emphasise the Wholesale Nature of the OTC markets, especially OTC derivatives and the tightly regulated status of all the market participants involved. Proposed regulation therefore will need to be focused on the parties to a trade rather than the product involved and to recognise the need to explicitly differentiate the intended impact of any proposed legislation on the separate wholesale and retail participant communities.

1.10 We do not recognise the OTC, or Derivatives Markets, as opaque. Rather the sheer scope, breadth and depth of the transactions do not lead to "Bellwether Reports."

1.11 Data is reported in a timely way to quote vendors at a maximum delay of sixty minutes and, as highly regulated entities, IDBs report trades to regulators. Furthermore the WMBA/LEBA remains in a position to provide regulatory authorities with aggregated price and volume transactions across all OTC and Derivative markets at a close of day periodicity. Notwithstanding full regulatory disclosures that currently exist, we reiterate the need for certain transactions to remain non- pre-trade transparent as a prerequisite for sufficient liquidity.

1.12 In their pursuit for greater transparency, we reiterate that the regulators distinguish between the interdealer and the dealer to client segments of the market in order to formulate the best regulatory framework. This should enhance the recognition of the role of the liquidity providers and differing mechanisms of price formations in the optimal functioning of the different wholesale and retail marketplaces.

1.13 IDBs, as a dimension of the flexibility inherent in their voice and electronic brokerage venues, do now offer the straight through processing tools required to link customers with clearing houses, settlement systems, securities depositories and a client's own middle and back office platforms. This facility is the foundation for both current solutions and new product development.

1.14 Mandating the entire wholesale OTC derivatives markets onto exchanges or regulated electronic trading systems that do not include encompass the entire product offerings of IDBs fails to recognise not only the substantial investments the IDB industry has already made to improve market infrastructure but also will discourage the industry from making such investments in the future.

1.15 WMBA/LEBA are keen to highlight that even in the equity markets, substantial traded volumes are executed OTC because of their size and overall sensitivity and then posted on the relevant exchanges. Similar to an exchange being able to operate, under its status, both outcry and electronic marketplaces, we recommend that any possible change in status that would aim at encouraging the execution of the trades in the OTC markets in a similar environment to that of exchanges not be limited to solely electronic means of execution and should encompass all the voice, hybrid and electronic marketplaces operated by the IDBs.

1.16 WMBA/LEBA believe that the CCPs are not in and of themselves a universal panacea and need operate in close cooperation with central banks in order to meet the objective of reducing any systemic risk. The shareholding and governance structures of CCPs should be reviewed with great care as the mere existence of the CCP is no guarantee of reaching the desired objectives.

WMBA/LEBA look forward to working with all relevant policy makers, legislators and regulators in the UK in order to develop the proper regulatory framework and standards in order to continue to serve own mutual customers in healthy global financial markets for decades to come while at the same time meeting the regulators' concerns without any detrimental effect on liquidity.

2. SPECIFIC RESPONSES TO QUESTIONS POSED IN THE COMMITTEE'S CALL FOR EVIDENCE

2.1 DERIVATIVES

2.1.1 *The economic benefits of derivatives*

The wholesale OTC markets offer a deep and liquid trading venue for professional market participants, such as major banks and financial institutions, to execute transactions, the key terms of which are normally individually negotiated. A difference should be noted between building liquidity in flow markets such as voice executed benchmark products and products accessible via MTFs) and non-continuously liquid markets where

voice brokered markets alone play the crucial role. After more than three decades of virtually continuous growth the wholesale OTC markets are, to say the least, very substantial in both volumes and numbers of transactions. Estimates of daily average individual OTC transaction totals are widely accepted to approximate two million individual trades corresponding to approximately \$5 trillion in volume across the range of FX, interest rate, credit, equity and commodity asset classes in both cash and derivative forms (*ICAP: the Future of OTC Markets*, *BIS: OTC derivatives market activity in the second half of 2008*). As such, it is no surprise that asset class innovation tends to originate within the OTC space.

Factors that have demonstrated the continuing economic benefits of the OTC markets over the past decade, and in particular the post-trade environment, are:

(1) *The growth of derivatives trading:*

The lower capital utilisation of derivatives makes these products a more efficient and attractive medium for trading than cash markets for many market participants. For this reason, trading volumes in derivatives are frequently a multiple of volumes in the equivalent underlying cash markets. Admittedly, in comparison with the cash markets, OTC derivatives transactions have historically created (a) more complex and longer-lived operational workloads, (b) medium or long-term contingent credit risk for participants on each other and (c) slower trade affirmation/confirmation procedures that can create time delays between a transaction being executed and it being officially recognised in the books and records of each counterparty. As we can all attest, significant measures across multiple constituencies have been taken, and are being taken, by the industry to address these problems (from, for example, such steps as the creation of MarkitWire and the development of the ISDA Collateral Support Annex to the initiatives of the Commission's Working Group on Derivatives).

Certainly, the explosive growth of OTC derivatives has marked not only the dynamics of how all assets classes are transacted but all these issues have also increased the complexity of the operational tasks facing all OTC market participants and have created significant capacity challenges for their middle and back offices.

(2) *The growth of electronic trading:*

Electronic trading has developed in many liquid, mature OTC markets as commoditisation, competition and narrowing bid-ask spreads oblige market participants (including IDBs) to find cheaper and more efficient execution channels for benchmark products for both themselves and their clients. Electronic trading also greatly increases the transparency of price formation and the resulting market activity. When electronic trading is introduced more advanced trading techniques become possible, such as model-based or low latency algorithmic execution. These enterprising tools boost trading velocity which in turn drives both steep volume growth and the increasing ticket numbers which have been the target of regulatory reforms.

(3) *Increasingly sophisticated investors:*

In recent decades, demographic change in the form of globalisation as an educational tool and spur to higher expectations, the availability of a wider array of financial products, the search for yield and the growing focus on absolute returns rather than meeting index performance has led to a seismic shift in the asset management industry generally and rapid expansion in the hedge fund industry in particular. This in turn fostered rapid growth in prime broking where the consolidation of borrowing, clearing, netting and settlement allowed more astute investors to widen their scope (and, over time, were seduced by generous leverage terms to over extend themselves).

Now, however, the Infrastructure that supported the prime brokerage industry has been called into question due to perceived concentration and counterparty risks. Nonetheless, the genie escaping from the bottle to expose end users to an array of derivative products will be a permanent fixture of the derivative markets going forward and, indeed, the requirement from these investors for bespoke products and hedges will ensure that derivatives remain a predominantly OTC market for the foreseeable future.

To expand upon this point further, the bespoke and individually negotiated nature of OTC contracts makes them much more attractive, and suitable, for hedging risk, especially in financial markets. Since exchange contracts are standardised and "real world" economic risk is normally non-standardised, traders and end users who access exchanges for hedging purposes will continue to carry the differential between their real underlying exposure and the delivery dates on their hedges. As a result, exchange contracts very rarely provide a perfect hedge for actual economic risk. By contrast, users of the OTC markets can hedge their risk precisely and transfer to professional OTC market participants their full exposure including the residual risk they would otherwise be forced to bear if

they had used an exchange product. This treatment also has important financial accounting consequences.

Accounting standards set tests for “hedge accounting” that require very close, or exact, matching of underlying risk with hedges for those hedges themselves to be allowed for capital optimisation purposes. These standards therefore oblige companies and other entities that are subject to these rules to use OTC markets rather than exchange products on most occasions.

(4) *The relationship between the OTC markets and the exchanges:*

The relationship between the OTC markets and the exchanges is often portrayed as competitive, but is in reality more often symbiotic. Certainly the peaks in either outstanding OTC volumes or global exchanges open interest would not have been attainable without the other. As we know, OTC and exchange markets each have separate, distinctive and logical reasons to exist, each of which has been reinforced by the recent market turmoil. One aspect of the professional OTC market which has contributed to its growth relative to the exchange world is the existence of “information symmetry” where the multiple information channels, hybrid execution venues and widely publicised trading prices renders access relatively equal for wholesale market participants. In the exchange arena, the mass arms race led by the most experienced “member” participants to control access to best prices, either in the form, for example, of lightning fast latency or privileged access to specific “dark pools”, renders competition more uneven. This sense of openness has been an important factor in the proliferation of the OTC sphere in our generation and will continue to hold sway going forward.

(5) *Regulation and Supervision in OTC Markets:*

All participants in wholesale OTC markets are professional in nature and are closely regulated as such. This allows the supervision and regulation of OTC markets to focus upon the market participants themselves rather than upon the products traded. It is critical to emphasise that both regulators and national supervisors can and do investigate trades conducted at IDBs to the same extent as at exchanges.

The Basel II Accord sets out the framework for the supervision and regulation of these participants by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk to which the bank exposes itself. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

This uniform regulation leads to an absence of regulatory arbitrage in the OTC marketplace. In virtually every commodity or asset class a wholesale market exists alongside a retail market. The wholesale market exists to allow major participants to assume and lay off risk between themselves in bulk. The retail markets exist to allow smaller participants to assume and lay off risk in the much smaller and specific quantities and description that they need. It is no accident that the two co-exist alongside each other. This symbiosis has also been fundamental to the expansion of the OTC markets. Forcing either large market players to lay off risk in a retail market or small market participants to use the wholesale market, as would be the case by mandating OTC products be transacted in an exchange environment, creates much bigger risk than separating the two sets of players into complementary markets.

Despite the fall-out from the recent financial crisis whose root causes as mentioned above lie principally not in derivatives per se but rather in structured credit products, their accounting and the behaviour of credit rating agencies, the development of the OTC markets has enhanced dramatically global risk mitigation and has contributed mightily to global economic growth over the past 25 years. A lack of comfort in credit and other derivatives is in our view a symptom of the underlying problem rather than its cause. It is important to distinguish between ineffective supervision of individual market participants and changes to, or the regulation of, market structure itself. The fundamental point is that the market crisis was caused by a lack of confidence in financial reporting and by the actions of individual market participants—not by a lack of confidence in market structure or processing. No market structure—neither OTC nor exchange—can determine the correct price for, for instance, a one-month unsecured inter-bank loan if there is material uncertainty about the repayment of that loan caused by overwhelming concern about the real or imagined financial state of the borrower as evidenced by its financial reporting.

The distinction is often made between “regulated” and “unregulated” markets, with exchange markets often presented as “regulated” due to the fact that exchanges are mandated to regulate the content, behaviour and participation in specified products. However, again, the perception that OTC markets are unregulated is incorrect. In contrast to exchanges, the primary regulatory focus in OTC

markets is on the participants themselves based on their activity, the nature of their counterparties and type of assets involved.

The CRD extends not just prudential principles but also systems and control requirements to all international parts of regulated groups that have EU headquarters. Automated Trading System and Multilateral Trading Facility regulations under MiFID and equivalent US and international regulations impose additional layers of regulation on electronic markets over and above the usual “regulated firm” rules that apply to operators and participants. The OTC derivative market’s rules of operation, valuation and netting have been agreed by trade associations in conjunction with regulators—such as the Master Agreements published by ISDA, the Securities Industry and Financial Markets Association (SIFMA), and the International Securities Lending Association (ISLA), all of which have been recognised by regulators, most importantly in the EU and US, as a valid basis for netting exposures for regulatory capital and risk reporting purposes.

OTC market activity is also itself subject to extensive codes of conduct set by regulators such as the NIPs Code in the UK, the multiple rules that have been created since MiFID, and international codes of best practice such as those produced by the Financial Markets Association (“ACI”). It may be tempting to regard the “regulated market” as the more robust model, but while exchange rules are certainly aimed at ensuring orderly markets.

Innovations in risk management originating in the wholesale markets, including clearing, have had a profound and hugely beneficial effect on the way in which corporations, investment firms and governments manage their financial risks. The more efficient allocation of resources and freer flow of capital that these tools have allowed has dramatically increased predictability and stability in government, corporate and individual financial planning and enabled much more rapid growth in the global economy relative to what would have been achieved without them.

The effects have been profound, down to the level of many millions of individuals around the world and the way they manage their personal assets, liabilities and retirement funds. Accordingly, the consequences of any changes to the structure or operation of the OTC markets need to be very carefully considered. We reiterate that the laws of unintended consequences may lead to increased costs of capital and reduced hedging capabilities for all participants and end users alike.

2.1.2 *The risks associated with derivatives and derivative markets*

Risks exactly parallel those found residing in all other financial exposures:

- price risk;
- credit risk;
- operational risk; and
- counterparty risk.

It should be noted here that the risk factors within derivatives enable real world exposures to be hedged or offset; therefore the risks associated with derivatives are orders of magnitudes smaller than those associated with their absence.

Some areas of risk may be exacerbated by leverage that is more simply generated in derivatives it should be noted that, while leverage is often seen as creating price risk, correct operations and accounting procedures should see these defined as operational and counterparty risks.

2.1.3 *Role played by derivatives in the recent crisis*

In contrast to the recent statements by both Chairman Gensler and by the EU Commission, it is widely accepted that derivatives did not play either a causal nor central role in the financial crisis. They were however widely and successfully employed as tools to implement and affect the policy easing of quantitative fiscal programs, monetary policy and terms of trade. In this sense they should be viewed more as part of the solution than the problem.

The causes of the recent crisis are evidently to be found in structured products, mortgage lending, ratings agencies, accounting standards for banks and inadequate supervision of disparate financial market participants.

The role of credit-derivatives was to function as an effective and prudent early warning system to the crisis in a way that cash markets were unable to replicate.

2.2 Clearing Directive

2.2.1 CCP Supervision at a National or EU Level. Possible benefits from a Directive in Clearing

WMBA/LEBA endorses further utilisation of CCPs by the market. We are generally supportive of a clearing directive in so far as the increasing systemic importance of CCPs requires more effective supervision. In accordance with the existing DeLarosiére principals, supervision should be both MacroPrudential and MicroPrudential with each role therefore defining itself into the EU and National spheres respectively. The benefits may not be evident in the UK where the FSA already fulfils its responsibilities, but it will put a minimum standards threshold level across Europe.

2.2.2 Provisions and Rules for CCP Regulation to Impose

The regulation should ensure that the convoluted governance structures of CCPs are brought under scrutiny in order to:

- (a) ensure that the Risk Boards of the CCP have operational authority over the management in determining what products are eligible for clearing, the metrics behind collateralisation of positions, how collateral is managed, or how the fee structure is determined;
- (b) ensure that there exists open, equal and fair access to clearing from all and any execution platforms (unbundling);
- (c) strongly encourages full interoperability between CCPs; and
- (d) explicitly states how each of the CCPs obtains and may employ an implicit guaranty from its host “lender of last resort”.

2.2.3 Mandatory Clearing for Standardised Derivatives

WMBA/LEBA notes that use of the term “*Standardised*” is confusing in this context and has been explicitly disavowed by both the FSA and the EU Commission.

Clearing Eligible contracts should not be mandated to clearing since the use of a CCP will come with attendant costs in margin, money transfer, deal processing, audit and regulation. None of these come cheaply and will likely need to be replicated across a plethora of CCP options. It may be, then, that even a zero-risk weighting may not be a sufficiently effective incentive for a client to access a CCP, and that this ‘design flaw’ may well vary across different market segments. We believe that such issues are a matter for the marketplace to decide with the caveat that end users need to be given suitable choice of CCPs to avoid concentration risk and to ensure that a single entity does not gain a monopolistically advantageous position.

The concerns of WMBA/LEBA revolve around the fungibility of OTC contracts against listed contracts which is an indicator of open and fair access to clearing. This may be aided by the interoperability of CCPs which directly benefits end users by optimising the deployment of their initial margins. In this way segregated, entity related accounts could be interoperable between clearing houses without breaking down internal buckets of margin. The bottom line, however remains, that it is the end user who needs to be given efficiencies and the CCP and its clearing members who must be responsible for the risks.

From the above it follows that end users may have individual reasons not to clear CCP-eligible CDS or other OTC products. Such end users as regulated entities will manage their risks with the national supervisors in accordance with the Basle II and the CRD. There is no need to penalise these entities fiscally, on top of and outside the CRD, since it is the task of the national supervisor to ensure they are acting in the interests of their clients and shareholders. Further penalties at a regional level may well engender unintended consequences such as driving transactions beyond regional boundaries and away from the interests of all stakeholders.

It further follows that should any exemptions be required from time to time or whether there should be any ratio, minimum or maximum metric of eligible cleared to non-cleared contracts then this is the responsibility of the national supervisors on a case by case basis. Again, the determinate of what is “clearable” is a function of the ability of GCMs to introduce, capture, monitor and maintain margin protection against positions on their books and not an external definition or proposed ratio of what should be cleared as levied by outside agencies.

2.2.4 *Capital Charges for Non Cleared Derivatives*

WMBA/LEBA note that this responsibility lies within the purview of the Basle Committee for Capital Standards and not driven by regulatory policy objectives. We applaud the recent comments from the Financial Stability Board that reiterate that such charges should be entirely a function of the economic risk standards and not some sort of disproportionate penalty charge aimed as an *inducement to clear*. This avoids the need to apply different treatments to the two categories if neither should be put up for clearing in any instance. We further note the zero risk weighting applied to cleared contracts.

2.3 TRADE REPOSITORY DIRECTIVE

2.3.1 *The benefits of using Trade Repositories*

We note that the costs of a central data repository would have to be borne by end users (in this regard we note the spiralling costs to end users being imposed by the FSA for the development of the “SABRE II” transaction reporting system). Whether these users would gain utility and become economic beneficiaries, and whether any central depository would offer the economies of scale derived from global reach would need to be proven a priori. The fear, otherwise, is that market efficiencies would be compromised in order to build an ill-conceived folly propelling the markets away from utilitarian, regulated and transparent venues.

Many financial institutions, not only banks who have committed significant funds to these projects, already use Central Data Repositories such as “TriOptima”. Therefore, WMBA/LEBA would consider this issue largely non-contentious. We agree with ISDA that it remains the end user and sovereign sectors that now need encouragement.

Whilst a central data repository may provide supra-regional regulators with a useful tool to view completed OTC transactions it is unclear how it could belie the risk management of a firm which may have hedges to many underlying positions. We believe that the strong and beneficial operation of national supervisors who can access all the risk of an entity is of paramount importance. It is not clear that such a repository would aid that function, and we would ask for further clarity between the objectives and requirements for central data repositories as opposed to CCPs.

Public disclosure needs to be separated from disclosure to regulators. Position level data of end users is private information and if disclosed to the public would compromise both the clients and shareholders of such institutions alike. We note that the imposition of the TRACE disclosures in the US at the start of the decade produced a distorted playing field that penalised providers of liquidity in the corporate bond market and incentivised end users to trade CDS product as a surrogate. Conversely, we again note that the aggregated end of day product flows across the IDBs could be of timely value to regulators and may be provided by WMBA/LEBA.

Given the granular nature of OTC markets it is uncertain exactly which specifics of matching and volume information are of more relevance, but benchmark indications would appear the most useful and trades of this type are all currently reported to the relevant quote vendors in a timely manner (often instantaneously) by automated electronic means. A wide range of live and indicative price data is currently delivered by the IDBs to our clients and the wider community—some for active clients only and some under reasonable commercial terms to all—and heretofore there has been virtually no calls from members of the public to receive trading data directly from the IDBs. Should this be the case, or should the Commission wish for the IDBs to widen the delivery scope of data provision, WMBA/LEBA are prepared to participate in that conversation.

2.3.2 *EU Regulation of the Legal Framework of Trade Repositories*

In order to gain sufficient efficacy, Trade Repositories would need to be global in scope. Therefore EU regulation would have to sit under the aegis of a supra-regional body such as IOSCO or the G20 directly.

2.3.3 *EU versus National Supervision of Trade Repositories*

The WMBA/LEBA has no issue with trade repositories being licensed and supervised by ESMA due to their macro-prudential nature.

2.4 FURTHER ISSUES

2.4.1 *The Market Abuse Directive under regulatory review to extend its scope to capture more OTC derivatives*

We note that the Commission have already given DG_Tren scope to rewrite the MAD, insider trading and transparency rules with respect to energy derivatives. LEBA have been consulted closely by Commissioner Piebalgs over the last two years in this process and look forward to maintaining this cooperation as it is self evident that the same rules cannot be stretched across a very heterogeneous derivatives landscape.

2.4.2 *Bilateral Collateral Controls*

The WMBA/LEBA is opposed to the use of position limits and considers the supervision of bilateral collateral as a micro-prudential issue. It is therefore the responsibility of the National Regulator. We have not seen collateral levels at a non-prudent low level and have not witnessed insufficient collateral as causal in provoking financial instability.

2.4.3 *Harmonisation of the Re-regulation of financial derivatives and the possibilities of Regulatory Arbitrage*

The WMBA/LEBA have been quoted in the media on many occasions recently warning of the dangers of regulatory arbitrage. We further note and applaud the recent strength in attempted coordination between UK, European and US regulators and Central banks.

Against this we would caution that it is not a purely transatlantic accord that is required, but one that sits across the G20 as a minimum, and even then the attractions of a more user friendly regime in Switzerland and in Singapore may stand out as a very real threat to the UK as a Financial Services centre.

Furthermore, we note with trepidation that the political arena, especially in the US has moved distinctly more isolationist over the course of 2010 so far.

2.4.4 *Further areas for regulation*

The WMBA/LEBA have always sought more and better supervision rather than further regulation. We champion competition, open access and horizontal structures that avoid the vertically integrated organizations which create a “*Too-Big-to-Fail*” hazardous landscape. We believe that competition added to effective supervision produces integrity and leads to a safe, sound financial environment.

APPENDIX 1

WMBA/LEBA Membership

- BGC Partners
- EBS Group
- GFI Group Inc.
- ICAP plc
- Martin Brokers (UK) Ltd
- Reuters Transaction Services Ltd
- Sterling International Brokers Ltd
- Tradition (UK) Ltd
- Tullett Prebon Ltd
- APX Power UK
- CantorCO2e Ltd
- Evolution Markets Ltd.
- GFI Group, Inc
- ICAP Energy Ltd
- PVM Oil Associates Ltd
- Spectron Group Ltd
- Tradition Financial Services Ltd
- Tullett Prebon Energy Ltd

1 February 2010