

“Achieving Meaningful and Lasting Reform in OTC Derivatives”

**A paper
from the International Regulatory Strategy Group**

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

Achieving Meaningful and Lasting Reform in OTC Derivatives

An International Regulatory Strategy Group Position Paper

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- Derivatives play a vital role in managing risk for financial institutions, investors and non-financial corporates. Both exchange-traded and OTC derivatives have a clear social and economic benefit.
- Europe accounts for more than half of all global OTC derivatives activity, and is home to several major derivatives exchanges. Taken alone, the UK is the world's largest OTC derivatives trading centre. Derivatives are an important contributor to the economies of the EU.
- Financial reform following the credit crisis is an essential process that market participants recognise as important and necessary. Regulatory change should address the true causes of systemic fragility and avoid erecting unnecessary barriers within competitive financial markets.
- The financial reforms contained in the US Dodd-Frank Act are an important step forward for the US economy and financial market participants. Regulators now begin work on rules required by the Act. The European Commission has recently published a proposal for a regulation on OTC derivatives and market infrastructure in the EU and is going to work further on financial legislation reforms. We believe that both US and EU regulators should cooperate further to inhibit the creation of national barriers and ensure a globally coherent approach.
- European derivatives legislation should fully address end users' needs and continue to allow users to enter into customised hedges and manage risks adequately. It is critical that such legislation is well-crafted, and does not drain market liquidity or unduly restrict risk management.
- EU legislation should allow for end users and market participants to trade derivatives via the execution method most appropriate for each product. Mandating a means of execution for any specific derivative class should be avoided. Those products that are suitable for exchange trading must be able to gravitate towards exchanges naturally and through the commercial selection process of exchanges, whilst those products that are not suitable for exchange trading must be able to be traded through the variety of OTC execution modes available.
- The flexibility embedded within OTC derivative markets should not be undermined in a move to push OTC execution on to exchanges or electronic trading platforms, regardless of the characteristics of the instruments concerned, the nature of liquidity, volatility, size of trades or nature of participation in the market.
- An important element of systemic risk reduction in OTC derivatives is the enhancement of the post-trade process. The industry has already collectively invested significant effort to reduce systemic risk in practical ways, such as building new clearing infrastructure and increasing the proportion of trades that are centrally cleared¹.
- If European legislation is poorly drafted or seeks to constrain markets unduly, then business may migrate to Asia.

- The following should be key goals for European policymakers:
 - EU legislation for OTC derivatives reform should remain focused on the core policy goals of systemic and operational risk reduction. European policymakers should ensure that:
 - legislation is tailored to each product segment and market, to ensure that benefits to systemic risk outweigh any negative market impacts.
 - legislation does not unduly harm the competitive environment under which Europe has fostered innovation and nurtured the world's largest OTC derivative centre.
 - the market remains user-friendly. Investors' interests should be considered explicitly in discussions on systemic risk reduction and operational efficiency measures.
 - Recognising the cross-border nature of financial markets, infrastructure providers should be allowed to compete on even terms regardless of location within the EU, while maintaining a high level of risk management standards.
 - To liaise closely with US regulators and legislators to ensure a globally coherent approach.
 - To ensure that regulation of the FX market remains focused on settlement risk – the dominant systemic risk. Any proposal to apply the mandatory clearing obligation to FX derivatives would have to be carefully analysed to ensure there are no negative impacts on the operation of CLS or, more generally, for Europe and the UK given the latter's importance as the world's largest FX market centre.
 - To ensure that disadvantages of increased transparency are recognised and weighed up against the benefits. Specifically, pre- and post-trade transparency should not be introduced inappropriately to OTC derivatives markets, to the detriment of market liquidity.

1. Derivatives play a vital role in managing risk.

Derivatives have existed in one form or another for centuries. Derivatives in their current form have been bought and sold since the 19th century with the term “OTC” (over the counter) derivatives used since the early 1980s to identify those instruments not traded on derivatives exchanges.

- Exchange-traded derivatives are standardised products whereby a formal exchange acts as a marketplace for the sale of futures and options. Increasingly, various parameters within the standardised terms (e.g. expiry date, exercise price) may be highly flexible.
- OTC derivatives are risk-transfer contracts that are privately negotiated between two parties, without going through an exchange. They allow corporates, investors and financial institutions to manage hedging needs that are not met by products traded on-exchange. OTC markets serve to facilitate both general and specific risk transfers at multiple levels of customisation – from highly standardised products to highly bespoke contracts.
- The OTC execution model by which such instruments are traded (bilateral negotiation directly between dealer and client) has functioned effectively for many years.

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 demand and growth in OTC derivatives (versus less flexible alternatives in the exchange traded and cash markets).

The global OTC derivatives markets total approximately \$600 trillion notional outstanding (before netting between counterparties). However, the gross market value of OTC derivatives (reflecting changes in prices of the underlying asset), stood at only \$21.6 trillion at end 2009. Furthermore, the counterparty risk associated with derivative contracts is mitigated by bilateral netting agreements, reducing global credit exposure to US\$3.5 trillion (this exposure is further reduced to \$1 trillion - \$2 trillion through exchange of collateral between contracting parties).

Interest rate derivatives account for roughly two-thirds of the global OTC derivatives market, FX derivatives (excluding spot/forwards) account for approximately 10% of notional outstandings, whilst Credit Default Swaps (CDS) form around 5% of the total outstanding OTC derivatives. OTC equity derivatives account for about 1% of outstandings.

Whilst the OTC derivatives market is large in terms of notional amounts outstanding, much of the turnover (the active use of contracts on an ongoing basis) in derivatives markets takes place on-exchange. For example, approximately 80% of the turnover in global interest rate derivatives is on-exchange, with the remaining 20% transacted in the OTC market².

Derivatives allow non-financial corporations to transfer financial risks to third parties, enabling them to focus on managing their core business. Derivatives support long term planning (e.g. through an exporter hedging foreign exchange exposure, or an airline hedging jet fuel prices) and enable capital intensive projects to be undertaken (e.g. through hedging of interest rate risk associated with the borrowings financing the project).

Interest rate derivatives play a critical role in asset and liability management for a diverse group of end-users across the globe, from governments and their agencies, non-financial corporations, and financial institutions including banks to pension funds and insurance companies. For example:

- **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 (e.g. LIBOR) in their domestic currency on their outstanding debt. In order to connect the corporate issuer with the end investor (often in a foreign country) 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.

- **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.
- The end result in these cases is a lower cost of company debt, less volatile corporate earnings and more secure insurance companies and pension funds. This translates into cheaper goods and services for consumers and higher, less volatile company earnings.

Credit derivatives, via CDS, have delivered significant benefits to the market through the pricing of credit risk and the ability to hedge and redistribute such risks – providing the market with a highly visible and transparent indicator of borrower creditworthiness. Lenders make use of CDS to hedge large exposures to specific borrowers or borrower groups. This increases their total lending capacity. Without the ability to hedge in such a way, certain borrowers would face higher costs of credit or be unable to obtain loan financing.

FX derivatives are crucial to international trade and finance, providing liquidity to cross-border trade and allowing exporters, importers and multinationals to hedge currency risk in their operations. Unlike most other OTC products, FX derivatives are generally settled by exchanging the full notional amounts specified in the contract (rather than the net change in value of the two amounts). The flexibility of the FX OTC market to deliver a certain amount of a certain currency on a certain date allows payments and receipts to be matched exactly.

Commodity derivatives allow the hedging of input and output prices for resource consumers and producers respectively. They allow corporates to protect themselves against volatility in their revenue and cost base, reducing their business risk.

Equity derivatives allow investors to efficiently obtain exposure to a wide range of equity underlyings, or to implement bespoke hedges of their investment portfolios. They allow corporates to hedge the risk of employee stock ownership schemes, or of new equity issuance.

ISDA's 2009 survey of the world's 500 largest companies showed that 94% of these companies used derivatives to manage and hedge their business and financial risks. 88% of companies used FX derivatives to hedge their risk, whilst 83% used interest rate derivatives.

There are risks associated with derivatives. However, the end user seeks to lower their net risk position by entering into the derivatives transaction. Market (price) risk and counterparty risk are usually the main risks associated with derivatives markets. However, participants in the market can also be exposed to operational risk (e.g. the risk of failed settlement for a trade, which is the dominant risk in FX markets, or delays in trade confirmation and post-trade processing³).

- **Market risk** – Participants in the derivative markets have the potential for gains and losses on the positions taken. However, if such positions are in the context of a (perfect) hedge, they

should not suffer an aggregate profit or loss (e.g. 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). OTC derivatives allow for customised hedging of risk. 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, by trading between banks in the wholesale financial markets, and on exchanges. Although exchange-traded futures and options generally do not allow for bespoke hedging of risks, they do provide highly liquid hedging tools for OTC contracts (in this and in many other respects the OTC and exchange-traded derivatives markets are largely symbiotic) and also facilitate price formation of such products through the provision of prices in a transparent, multilateral environment. Participants using such contracts to hedge a risk are likely to have some residual exposure to the underlying position (i.e. basis risk).

- **Counterparty credit 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 (i.e. the risk that the counterparty may not honour its obligations under the contract). Counterparty risk is more prone to contagion than market risk. Hence regulatory change has focused on minimising counterparty risk.

OTC derivatives are generally traded bilaterally and by voice execution. However, many OTC products can be traded electronically with dealers competing on price, while still allowing for bilateral agreement. Indeed, a high level of multilateral pre-trade transparency already exists in the OTC derivatives markets.

- Banks play a critical role in the OTC market as providers of liquidity, rather than simply agents providing access to a pool of tradable prices.
- In OTC derivatives markets, end-users are unlikely to have exactly equal and opposite needs that can be matched easily. Banks therefore facilitate the needs of institutional investors and corporates by entering into trades with such clients, aggregating the aforementioned specific risks within their wider book of risk and then managing the hedging of their overall position in the wholesale OTC or exchange-traded derivative markets.

Trades between financial institutions are generally centrally cleared or bilaterally collateralised to minimise counterparty credit risk (particularly between financial counterparties). In both cases the derivatives contract will require counterparties to settle financial obligations as they arise over the course of the contract.

In bilateral collateralisation both parties will mark-to-market (MTM) contracts so as to monitor the evolution of their value. Should the MTM process show that one counterparty has built up a claim on the other it is then entitled to ask the other counterparty for collateral in order to mitigate the risk that they may not eventually honour their obligation or may default during the lifetime of the contract. This process is undertaken on a daily or weekly basis. Cash is currently the dominant source of collateral, amounting to 84% of collateral received in 2008. Cash is exchanged on a net basis (i.e. 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 (i.e. accumulation of debits in one derivative market segment compensated by the accumulation of credits in another). Government securities are the second largest source of

collateral. Other sources are corporate bonds, letters of credit and commodities. Netting of positions between counterparties can reduce exposure by 80-90%.

Under central clearing, the single contract between two initial counterparties that characterises an OTC trade is replaced by two new contracts – between the central counterparty (CCP) and each of the two contracting parties. This process is referred to as “novation”. The original buyer and seller are no longer counterparties to each other; instead, each adopts the CCP as its counterparty. The mark to market valuation used during central clearing is an independent figure, produced by the CCP based on the best available data sources, including prices submitted to the facility.

- Use of a CCP for clearable contracts makes sense for systemically important financial institutions – in particular the major dealers but also the other large financial institutions that participate in some size in the markets.
- 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 aids transparency for regulators by making information on market activity and exposures available to them. These benefits can only be realised if the structure is well designed, subject to robust prudential requirements including sound risk management and governance, and the contracts being cleared are suitable for clearing. Otherwise, risks would quickly concentrate in the CCP and the CCP itself would create a systemic risk. Thus, careful consideration must be given to specifics of each CCP and the eligibility of classes of derivatives for central clearing by regulators and market participants.

However, the move from bilateral collateralisation to central clearing reduces the benefits arising through cross-margining since what was once a single OTC derivative portfolio becomes fragmented as different derivative products within that portfolio are cleared by separate CCPs.

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 change in value of their derivative trades. In effect, the bank extends credit (representing the potential future change in value of the derivative transaction) to the end-user and charges an appropriate credit fee for doing so. In doing so, the end-user utilises the overall credit limit it has with the bank. This reduces complexity for the end-user who may not have the operational capacity to manage the daily funding associated with collateral calls.

Furthermore, non-financial companies are, in most of their risk management activities, hedgers of cash flows rather than hedgers of financial assets. The need for margining makes margined exchange traded contracts much less suitable for non-financial corporates versus non-margined OTC contracts. Credit considerations mean that some large companies will be unable to accept such large contingent liabilities of the counterparty (bank) to the company and will require margin from the bank – usually with a large threshold and settled weekly or less frequently – or may put some of their activity on exchange. For very large exposures, and given other exposures to the company from other business, some banks may seek margining of some element of activity. Given the smaller and more concentrated credit portfolios of non-financial companies compared to those of banks, companies normally impose a much lower credit limit for the bank than the bank imposes on the company.

2. The OTC derivative markets are important to Europe

Europe is home to more than half of all global trading in OTC derivatives. Taken alone, the UK 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). New York is a comparatively small centre for OTC derivatives, except for credit derivatives. Other financial centres including Hong Kong and Tokyo account for a smaller share of global OTC derivative turnover.

- Interest rate derivatives: Europe accounts for 65% of global trading in interest rate derivatives, whilst the US accounts for 24% of volume⁴. The UK alone accounts for 46% of global interest rate derivatives volumes (having grown its share from 28% in 1995).
- Foreign Exchange: Europe accounts for 57% of global trading in FX, including FX spot, forward and derivative markets, whilst the US accounts for 18% of turnover. The UK alone accounts for 37% of the global FX market. In FX derivatives alone, the UK accounts for 39% of global turnover⁵ (up from 31% in 1995), whilst the US accounts for 15% of FX derivative turnover. Hong Kong and Japan account for 5% of FX derivative turnover apiece.
- Credit derivatives: Europe accounts for approximately 50% of global turnover in credit derivatives. The UK alone accounts for around 40% of the global credit derivatives market whilst the Americas (largely the US) account for roughly 40% of credit derivatives business also. Japan is responsible for 5% of global turnover⁶.
- Equity derivatives: European equities account for 62% of outstanding OTC equity derivatives, whilst US equities account for 23% of outstandings⁷. This picture has changed little in the past 10 years and reflects the much larger structured product market in Europe.

Three of the major OTC derivatives intermediaries ('interdealer brokers') are headquartered in Europe (ICAP and Tullett Prebon based in the UK; Tradition in Paris). These intermediaries predominantly focus on voice broking although they do operate electronic trade matching services.

Europe is also a significant financial centre for exchange-traded derivatives, with much infrastructure that facilitates on-exchange trading being based in the region. Alongside Chicago-based CME, the world's largest futures exchanges include German-Swiss Eurex and UK-based NYSE Liffe, the derivatives business of NYSE Euronext.

Europe is home to one of the world's largest OTC derivative clearinghouses, LCH.Clearnet, operator of the Swapclear interest rate derivative CCP. Furthermore, ICE Clear Europe (owned by ICE) operates the European infrastructure of their global CDS clearinghouse from London. Several OTC derivatives clearinghouses have recently been launched (e.g. by CME, Eurex). In addition, NYSE Euronext is building two new clearing houses, in London and Paris.

3. Proposed regulation aims to make OTC derivatives markets safer. Some proposals may however significantly disrupt and reduce the size of the OTC derivatives markets.

The bailout of AIG and collapse of Lehman Brothers prompted calls for reform of the CDS market. This then expanded into a request for a holistic 're-regulation' of the OTC derivatives market.

- 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, illiquid OTC derivatives (thus unsuitable for clearing). 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 have collapsed.
- Whilst the move to central clearing of OTC derivatives is to be welcomed, this would not have prevented the losses sustained by AIG since much of these losses related to non-clearable OTC derivative positions (these bespoke derivatives should be distinguished from the vast majority of liquid Credit Derivatives – their overall outstanding amount being very small in comparison with the flow CDS market). The losses suffered by AIG were due to a comprehensive internal failure to manage the aggregate risk it had taken on, coupled with an over-exposure to the US sub-prime market (only part of which was through derivatives). This situation was exacerbated by AIG posting sub-prime securities as collateral which dropped in value as the underlying real estate market deteriorated in value. Greater regulatory oversight of AIG overall, including the true quantification of AIG's trading positions, may have prevented AIG from becoming so exposed, but reform of execution and clearing infrastructure would not.
- There is little evidence that the collapse of Lehman Brothers was caused by Lehman's role as a major derivatives dealer – instead its outsized exposure to real estate was the most significant factor. However, the CDS market provided the transparency through which the market could assess the likelihood of Lehman's default. In fact, CDS prices on Lehman proved to be a fair reflection of its precarious business model as the US recession deepened.

In the US, the legislation on OTC derivatives embedded within the Dodd-Frank Act, has evolved into a wide spectrum of changes. This legislation has been signed into law, with detailed rules now to be drafted by the CFTC/SEC, along the following lines:

- **Central clearing** – Mandatory clearing for standardised derivatives through Central Counterparties (CCPs) with differentiated capital charges between CCP and non-CCP cleared trades. Customised contracts will continue to be cleared bilaterally, but all firms will have to hold a larger amount of collateral. Clearing of swap trades of customers will need to be conducted through "futures commission merchants", (FCMs), which are regulated by the CFTC. There is, however, an end-user exemption whereby a commercial end-user which is not a financial entity and which uses swaps to hedge business risks is not required to have its swaps cleared (subject to notification requirements to the regulators). However, in practice may be difficult to define hedging activity clearly.
- **Exchange/electronic trading** – Swaps that are cleared will also be required to be traded on an exchange or Swap Execution Facility (a SEF is an organised trading venue which may closely resemble an exchange) unless there is no exchange or SEF that accepts the swap for trading.
- **Standardisation** – Non-standard products to be discouraged through higher capital and collateral charges. It is not clear yet how standardisation will be reflected although there are indications that there is no desire to make any product uneconomic.
- **Trade repositories** – Mandatory reporting of OTC derivatives to regulated trade repositories

- **Real-time public reporting** – Most swaps will be subject to “real-time” price and volume reporting requirements to the public.
- **Swaps push-out** – Requirement for banks to separately capitalise part of their OTC derivatives trading business in a subsidiary entity.
- **Scope** – No clear extra-territorial limits on ability of US regulators to regulate foreign transactions outside the US. Furthermore, the legislation mandates that clients access Derivatives Clearing Organisations (“DCOs”) via FCMs.

In Europe, the European Commission is closely following the essence of the G20 mandate (as has the US in the Dodd-Frank Act)⁸, and having explicitly stated its desire to avoid creating regulatory arbitrage. Its stated policy actions in general mirror those of the US and will be delivered via various new laws and amendments to existing legislations. The legislative process incorporates the following:

- New legislation on CCPs, trade repositories, reporting for OTC derivatives via EMIR (European Market Infrastructure Regulation). A consultation on this topic closed on 10 July and draft legislation has just been published.
- Amendments to the Markets in Financial Instruments Directive (MiFID), covering trading on organised venues, transaction reporting and position limits. A consultation on exchange-trading of OTC derivatives was launched by CESR⁹ (the Committee of European Securities Regulators) on 18 July. This proposed to incentivise as much as possible the trading of OTC derivatives on exchange/electronic trading platforms.
- Amendments to the Capital Requirements Directive to increase capitalisation of non-CCP cleared OTC trades.
- Proposal to extend the Market Abuse Directive (MAD) to cover OTC derivatives.
- Furthermore, the EU has proposed restrictions in the trading of CDS as part of its recently-closed consultation on short selling.

The scope of emerging legislation is likely to cover all financial firms and virtually all OTC derivative products, including FX.

- Banks, asset managers, hedge funds and insurance companies will generally be required to make use of central clearing, collateralisation and be subject to prudential capital requirements.
- Whilst non-financial corporates hedging commercial risks will be excluded from the majority of regulations, significant firms beyond a critical exposure/activity threshold will likely merit some regulatory oversight or tighter restrictions on non-hedging activity.
- Regulators declare that their intention is to cover all OTC derivatives asset classes. The inclusion, or otherwise, of FX derivatives within the proposed OTC derivatives reform will be critical to the UK, given its role as the world’s largest FX trading centre.

In crafting the global regulatory response it is critical that firms have equal access to customers, clearing members, and clearinghouses on equivalent terms globally. The principles behind such access should ensure the avoidance of impediments to international trade and investment flows.

- Pursuant to the G20 mandate, all major economies will have an equivalent mandate to clear derivatives. Thus any derivative transaction between two institutions incorporated in any two G20 countries will be subject to at least two competing clearing mandates. Provided that these mandates simply require central clearing, this is unproblematic. However, if these mandates require clearing through national systems, then almost every derivative will be

subject to competing and potentially conflicting clearing requirements. It cannot be overemphasised that a derivative cannot be cleared through two different CCPs, and if the rules require this then the rules in effect prohibit that derivative.

- Once all of the relevant systems are established and have a track record it may be possible to establish a mutual recognition regime. However for the time being, in order to create an international mandatory derivatives clearing regime, it will be appropriate for at least G20 members to accept that clearing is clearing, regardless of where it occurs.
- Financial market participants strongly support fair and open reciprocal access to third country CCPs, clearing members and customers. International regulators should work to inhibit the creation of national barriers to this objective.

Regardless of the role of OTC derivatives in the crisis, reductions in systemic and operational risk in the OTC derivative markets are desirable and achievable objectives of the regulatory process. The industry recognises the significant social benefits of regulatory change in OTC derivatives (e.g. from greater central clearing, reporting to trade repositories). However, the fluidity and pace of regulatory change has to date created significant uncertainty for end users. Moreover, some of the current proposed legislation has the potential to make structural changes to OTC derivatives markets which may significantly disrupt Europe's OTC markets and harm end users. End users should be allowed to continue to enter into customised hedges using OTC derivatives and in doing so manage risks adequately. To the extent that legitimate OTC derivatives activity is made prohibitively costly or effectively prohibited (e.g. via inappropriate mandates for central clearing, collateral/capital requirements or electronic trading) then end users will suffer.

4. Europe will be best served through policy that truly targets the reduction of systemic risk, by enhancing rather than dismantling the OTC model.

Whilst a common international framework for the regulation of OTC derivatives is desirable, European legislation should not simply copy that enacted in the US. European regulatory change should focus purely on the reduction of systemic and operational risk. Market participants welcome this regulatory change and are fully engaged in creating meaningful benefit from the process.

Clearing

It is generally agreed that CCP-clearing should be rolled out more widely. For central clearing to function effectively and reduce systemic risk, CCPs and their member firms should be able to risk manage the contracts effectively. A contract that is standard in its terms may be complex in its payoff, and therefore such risk may be best managed on a bilateral basis. In this way only “eligible” contracts (i.e. those that a CCP has first assessed that it can risk manage) should be centrally cleared rather than all “standardised” derivatives.

It is fundamental that a CCP’s decision to clear eligible contracts be determined by its members, via the CCP’s Risk Committee. The Risk Committee ensures that the CCP is able to risk manage the particular product effectively, and avoids unduly burdening the CCP’s members who are each mutualising the risk.

In determining suitability for central clearing CCPs need to have regard to contract term standardisation, potential liquidity, the availability of robust valuation information and the ability of market participants to participate in the process (in particular the default management process). As recognised by the European Commission, in addition to not all OTC derivatives being suitable for CCP clearing, not all CCP-cleared OTC derivatives are suitable for mandatory CCP-clearing. Therefore exceptions need to be considered in areas where any clearing obligation may not lead to the reduction of systemic risk. Mandating central clearing for inappropriate derivatives would lead to a build-up of systemic risk within the clearing house, as the CCP would be unable to risk manage the contract effectively.

The European Commission recognises that not all trading counterparties should be required to use central clearing. Certain counterparties (e.g. 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 (e.g. management of liquidity for the purposes of meeting margin obligations) should be exempted. Furthermore, smaller financial institutions trading *de minimis* volumes should be exempted from CCP clearing obligations.

Clearing should not be mandated in circumstances where it would increase bilateral risk. To the extent that not all products will be able to be cleared, so it will be the case that offsetting risk trades may be split up, with some having to be cleared, thereby increasing bilateral exposures and systemic risk.

The market will be best served by a limited number of CCPs, worldwide. This maximises the risk reduction and netting benefits provided by each CCP and prevents the costly formation of unnecessary infrastructure by CCPs and their member firms. Therefore, regulators and governments should not require the formation of separate CCPs in each jurisdiction and asset class.

A uniform pan-European regulatory framework for CCPs, including high standards for risk management, should be developed. This framework and its risk management standards should be consistent with standards in the US.

- European legislation should 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.
- CCPs should be encouraged not to compete on price (i.e. the amount of margin required for a particular position) but rather on the quality of their risk management and the service offered.
- Assets of CCP members should be segregated from those of end users.
- National insolvency laws that frustrate or impede client segregation and portability in the event of a member default should be set aside.

It would seem essential for CCPs to be regulated at a national level (rather than European level) as such entities may ultimately fall back on the support of national authorities in the event of failure (the European Commission recognises this in its draft EMIR legislation, however the Commission's proposal of a 'college system' as a means of achieving consistent rules for CCPs in different jurisdictions, which deals with such matters as CCP authorisation, review of risk models and interoperability, must not be allowed to create a cumbersome and inefficient process for reaching regulatory decisions). It seems clear that the new European Securities Markets Authority (ESMA) will have authority to express a formal opinion on which contracts should be centrally cleared. ESMA will also be responsible for creating a harmonized rule book for clearing.

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). However, capital for non-CCP cleared trades should not be set at a punitively high level so as to prevent or discourage genuine hedging and risk management by corporates and financial institutions using bespoke contracts.¹⁰

It will also be important to consider that clearing does introduce additional costs for users of OTC products and to the extent these exceed the value of the risk mitigated, it may cause users to cease to use OTC products or to use alternate products, with the consequence that additional risk is likely to result. Liability-driven investment ("LDI") funds, a thriving UK-originated business sector has made representations of this nature via the Investment Management Association submission to the EU Commission.

Trade reporting/Transparency

Much of the debate around exchange/platform trading is directed at addressing perceived lack of price transparency (pre- and post-trade) in the OTC derivatives market and at addressing the difficulties regulators have faced in obtaining an accurate overview of the various OTC markets. However, price transparency already exists, for instance via quotation requests. Furthermore, given the large size and bespoke nature of many OTC derivatives trades, it is not practical to target public dissemination of pre-trade market prices given that each trade will be priced on its individual characteristics, and on the prevailing market conditions at that time. Given the highly bespoke nature of potential transactions, price levels are of highly significant interest to competitors in the market, but of limited interest or use to the wider market. Any imposed dissemination of information would thus imply a significant added cost to trading but serve little or no public interest.

Moreover, any publication of traded/cleared trades in real time (or without sufficient time lag) could lead to the destruction of liquidity in large size or less-liquid trades, as such transparency

exposes the counterparties to the market trading against such a position. Even in highly liquid, fungible, equity markets many trades qualify for delayed post-trade reporting.

In all cases, regulators should have access to timely and adequate information to monitor the buildup of risks within an institution or product. Enhanced regulatory reporting for OTC derivatives should be rolled out, including trade reporting to a Trade Repository (with access for relevant regulators) and position reporting direct to regulators by financial institutions carrying principal risk.

The primary purpose of the trade repository is to provide 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.

Trade repositories should be introduced in all OTC derivative asset classes. Industry working groups are already working on such projects, to create trade repositories where they do not currently exist.

- To satisfy the needs of global regulators in the most efficient and practical manner, regulators should work together to determine a consistent global legal framework that allows a limited number of trade repositories to be built but enables all relevant regulators to have unfettered access to perform their regulatory responsibilities. 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 (e.g. operational resilience, transparency, legal basis).
- The same criteria as apply to CCPs in respect of quality of infrastructure and protection of data, should also apply to trade repositories.

Such repositories are best operated as a utility to obviate any monopolistic pricing behaviour by a repository operator.

Electronic trading/Standardisation

The reduction of systemic risk in OTC derivatives markets is best served by enhancing the post-trade process rather than insisting on what might be an inappropriate electronification of the point of execution. Indeed, reducing systemic risk through CCP clearing, enhanced bilateral risk management, legal and process standardisation, and general electronification can occur (and is already occurring) independent of the specific execution method.

Imposing full exchange-trading, or more generally the electronic matching of buyers and sellers, is not achievable, nor a desirable regulatory goal for the majority of OTC products. For example, given the bespoke nature of OTC derivative contracts (e.g. widely varying tenors even for simple interest rate swap contracts) it's not realistic to have buyers and sellers executing against one another automatically. Indiscriminately electronifying the execution process may even be detrimental to OTC derivatives markets, and have a knock on effect for end users and market participants. Furthermore, it is not a necessary condition to lower systemic risks in OTC derivative markets¹¹.

- Mandating electronic trading across OTC products would severely impact parts of the OTC market, as there is insufficient liquidity in some contracts to sustain trading on organised markets.

- The Committee of European Securities Regulators (“CESR”) and the European Commission are considering creating incentives for the trading of standardised OTC derivatives on organised trading platforms. This needs to be carefully considered, given that the balance of costs and benefits is likely to differ between products. Benchmark OTC products which are standardised, suitably liquid and for which enough trading counterparties exist may be suitable for trading on organised platforms, but other OTC products are unlikely to be suitable.
- Reducing the ability of market participants to fully hedge an exposure, through the replacement of bespoke OTC derivatives with standardised exchange-traded derivatives would be a detrimental outcome of any OTC derivative reform.

Fundamentally, OTC instruments should not be forced to be traded via a particular mode of execution – The market should be able to choose the most effective execution method for trades of such type, including an electronic solution that is appropriate for counterparties and end users. In the short term, end users should be able to continue to use voice execution should they so choose (this is the situation today where many brokers offer mixed voice and electronic execution services).

- Those products that are suitable for exchange trading must be able to gravitate towards exchanges naturally and through the commercial selection process of exchanges. Suitability for exchange-trading will be dictated by product standardisation, frequency of trading, depth and continuity of liquidity and the number of market participants. Those products that are not suitable for exchange trading must be able to be traded in the most appropriate manner. Indeed, the varying characteristics of the OTC derivatives market call for a continuum of modes of trade execution.
- The appropriate level of post trade transparency can be achieved irrespective of the mode of execution.

The post-trade process can be significantly ‘electronified’ to the benefit of the current OTC market model. Product standardisation is not a pre-requisite for operational and systemic risk reduction. Electronic confirmation and lifecycle management for substantially all contracts can be achieved without product standardisation and without damaging liquidity.

- At present, post-trade automation levels differ markedly across asset classes and products: FX product processes generally show the highest levels of STP (straight-through processing) automation, followed by Credit and Rates, with Equity and Commodities typically the least automated.
- However, there are often wide variances within each product sub-segment, so improvements across all asset classes can be found.

The industry should continue to work on enhancing post-trade process automation across OTC derivatives products, particularly among those that are ineligible for central clearing, and focusing on those areas of greatest risk as a priority.

Swaps push-out

The US requirement to separately capitalise (part of) banks’ OTC derivatives operations (the ‘swaps push-out’) was initially proposed to prevent banks being able to rely on taxpayer support in any subsequent crisis. It was originally argued that banking entities with insured deposits should not be allowed to trade OTC derivatives, based on the perception that these products are

riskier than traditional banking activities. Thus OTC derivatives operations should be 'pushed out' in to a separate entity and be separately capitalised.

Ultimately, certain products including interest rate swaps were exempted from this requirement. Splitting OTC derivatives trading operations between entities therefore fails to meet the original stated objective.

Unintended consequences of this requirement may be that certain OTC derivative activities will move to less well-capitalised entities and netting efficiencies will be lost as the overall OTC derivatives portfolio is split.

Capital levels for OTC derivatives operations should be decided at a whole-firm level, rather than requiring a portion of capital associated with OTC derivatives to be tied up inefficiently in a separate entity and in a specific country, as will be the case for US institutions.

Credit Default Swaps

A lack of understanding of Credit Default Swaps (CDS) has suggested that the practice of 'naked shorting' of CDS is improper or damaging to financial markets and the wider economy.

It has been claimed that 'naked shorting' is speculative gambling that is without social and economic benefit. This is a common misperception in that what may appear to be 'naked shorting' is often a hedging activity to protect against a potential decline in value of financial assets (other than the underlying bond), which has a clear economic and social value. CDS are commonly used for 'proxy hedging' in circumstances where a direct hedge is not available or not cost-effective.

For example, a pension fund may hold a bond issued by a mid-sized Swedish company. Whilst it may not be possible to buy a CDS for the bond in question (due to the small size of the company), the pension fund can buy CDS on a Swedish government bond. As government and corporate bond prices generally move together, if the pension fund suffers a loss on the corporate bond it holds, this will be offset by the increase in value of the government CDS it holds (effectively the 'proxy hedge' has become more valuable). The pension fund has thus hedged its risk and has protected the assets of its policyholders.

Specific CDS trading restrictions in the EU should be avoided. Instead, the broader OTC derivative regulatory reform process will provide the stability that regulators and market participants require.

References/Notes

¹ Interest Rate Swaps have been cleared by LCH.Clearnet since 1999. CDS clearing has successfully been launched in Europe by ICE Clear and LCH.Clearnet. Through May 2010, approximately \$9 trillion of CDS trades and over \$210 trillion of interest rate swaps (IRS) have been centrally cleared. In September 2009, ISDA and 14 large market participants committed to clearing 95 percent of new eligible CDS trades and 90 percent of new eligible IRS.

Sources: <http://www.isda.org/media/press/2010/press061410.html>

<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1215&format=HTML&aged=0&language=EN&guiLanguage=en>

² Source: "Triennial Central Bank Survey: Foreign exchange and derivatives market activity in April 2010", BIS, Sept 2010. Interest rate derivatives volume comparison based on daily average trading in April 2007. Exchange-traded derivative data sourced by the BIS to FOW TRADEdata, Futures Industry Association and various futures and options exchanges. OTC derivative figure used is for single currency interest rate contracts only.

³ It is important to note, however, that the industry has largely addressed infrastructure issues identified to date. For instance, there is less than one business day's worth of aged confirmations outstanding for CDS, IRS and equity swaps.

Source : <http://www.isda.org/media/press/2010/press042310ops.html>

⁴ Source: "Triennial Central Bank Survey: Foreign exchange and derivatives market activity in April 2010", BIS, Sept 2010

⁵ Source: "Triennial Central Bank Survey: Foreign exchange and derivatives market activity in 2007", BIS, December 2007

⁶ Source: "BBA Credit Derivatives Report 2006", BBA, 2006

⁷ Source: "BIS Quarterly Review", BIS, September 2009

⁸ On 25th September 2009, G-20 leaders agreed that: "All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements".

⁹ Source: "Standardisation and exchange trading of OTC derivatives", Committee of European Securities Regulators, July 2010

¹⁰ The relative incentives for central clearing versus bilateral exposures are strong and have resulted in \$9 trillion of CDS trades and over \$210 trillion of interest rate swaps (IRS) being centrally cleared, as of May 2010. The incentives, whereby collateral and mark to market exposures to CCPs are zero, should continue, given the risk management and operational security provided by CCPs. At the same time, it is evident that there are many contracts that either cannot safely be cleared or can usefully be kept in a bilateral portfolio, because they offset exposures incurred via other contracts that cannot be cleared. The risk weighting of bilateral exposures should be strictly loss-based and should not be increased to address issues being targeted through other measures, such as the measures for wrong-way risk.

Sources: 16 April 2010 AFME, BBA and ISDA response to the European Commission on CRD 4, p.39

http://www.isda.org/uploadfiles/_docs/AFME_BBA_ISDA_Response_to_CRD_4_160410.pdf

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<http://www.isda.org/media/press/2010/press061410.html>

¹¹ Source: "Reforming OTC Derivative Markets – a UK perspective", FSA/HM Treasury, December 2009