NVB | Nederlandse Vereniging van Banken

DACSI | Dutch Advisory Committee Securities Industry

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POSSIBLE INITIATIVES TO ENHANCE THE RESILIENCE OF THE OTC DERIVATIVES MARKETS

The joint response to the European Commission of the Netherlands Bankers Association (NVB) and the Dutch Advisory Committee on Securities Issues (DACSI)

The Nederlandse Vereniging van Banken (NVB / Netherlands Bankers Association)[1] and the Dutch Advisory Committee Securities Industry (DACSI)[2] together represent the voice of the Dutch wholesale banking market. As such the opportunity to comment on the European Commission's consultation document on possible initiatives to enhance the resilience of OTC Derivatives Markets is as welcome as it is timely in view of the changing regulatory landscape following the recent economic and financial crisis.

The NVB is an active member of the European Banking Federation (EBF) and has contributed to and supported the EBF's positioning on this and related issues to date. The NVB wrote to Commissioner McCreevy in late 2008 to offer its support for the establishment of central clearing counterparties (CCPs) for the clearing of Credit Default Swaps (CDS). Through the EBF's letter of 17 February 2009, the NVB has furthermore committed its members to work towards further migration of derivatives contracts to CCP clearing and wider aims in relation to strengthening the OTC Derivatives Markets.

This joint NVB-DACSI response similarly is in line with the key messages promoted by the EBF and the wider banking industry consensus on the issues. It takes into account the needs of the sell side and buy side as well as large and small players focused on both cross-border and domestic operations.

General remarks

The Dutch market strongly believes that the OTC markets should have a strong future – we therefore support efforts to standardise the processes related to clearing derivatives but reject any further moves towards a large scale standardisation of derivatives contracts *per se.* It is above all important to note that central clearing of derivatives does not depend on derivatives contracts being traded on a regulated market.

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[1] The Nederlandse Vereniging van Banken (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

[2] DACSI is the principal not-for-profit association in the Netherlands for firms active in the securities industry. The Association represents the interests of its members in all aspects of their securities and securities related business and positions the Dutch view to the market infrastructures service providers and regulatory authorities in the Netherlands and the European Union. Its members institutions are active in the Netherlands in the securities and derivatives industry, mostly banks or (other) members of regulated markets, central counterparties or the central securities depository.

Banks fully appreciate the importance of having well regulated, efficient and competitive venues for trading in the most liquid and standardised financial instruments whilst leaving space for trading less liquid and typically larger ticket trades over the counter (OTC). From the outset, it should be well understood that regulated markets are functionally complimentary to, and not a substitute for, the OTC space. *A priori,* the Dutch market is concerned with the Commission's hypothesis that it could be desirable and possible to move part or all of Derivatives trading on exchange.

It is therefore important to restate that OTC markets offer a deep and liquid trading venue for professional market participants to execute transactions, the key terms of which are individually negotiated, rather than standardised. The OTC space is furthermore an arena for asset class innovation. Bilateral risk management contracts, i.e. derivatives traded OTC, are a highly efficient means of adjusting risk exposures and improving pricing efficiency because they may reveal prices for risks that were not previously priced separately. Hedging and pricing individual risks are two key functions of OTC markets and are therefore pivotal to efficient risk management across the finance sector. In order to allow banks to manage their exposures vis-à-vis other banks and vis-à-vis the exchanges, it will be necessary for them to retain the right to withhold some proportion of their trades out of clearing and/or exchange trading.

The OTC markets are dynamic. Market evolution is necessary and welcome and the restoration of the health of the financial markets should not be hampered by overly stringent regulation introduced in times of crisis. As a complement to enhancing transparency and risk management standards, greater operational efficiency in the OTC space could further reinforce the market's credibility. Encouragingly, there is a general consensus in the market around the specific changes that need to be made in the way OTC markets operate.

Overall, we feel that the European Commission has identified the right issues to consider in its consultation document and benefits from wider coordination with global partners on the issue. However, we reiterate our concern with the assumption that trading derivatives on exchange is either necessary or desirable to enhance long term financial stability. This is simply not the case, as we will explain further on in our response.

Detailed remarks[3]

Standardisation

To be eligible for central clearing, OTC Derivatives contracts require further standardisation. We generally support the Commission's analysis in this section that standardisation of processes around clearing generally increases efficiency and reduces operational risks. However, it must be noted that not all OTC Derivatives contracts could be standardised. Importantly for the health of the financial markets, it is not always desirable to pursue standardisation of each and every OTC Derivatives contract. After all the purpose of trading over the counter is to hedge specific risks in specific circumstances. An overzealous drive towards ever more standardisation therefore brings with it risk, most notably undermining sound risk management practices.

(1) What would be a valid reason not to use electronic means as a tool for contracts standardisation?

The Dutch market supports the use of electronic means for transaction processing and in particular as far as electronic trading and automated affirmation and confirmation of trades is concerned.

[3] Please note that where answers to specific areas of the consultation are not included the Dutch community did not provide specific views in addition to those presented by the European Commission.

We would also support further standardisation of the legal parameters governing derivatives contracts such as master agreements.

(2) Should contracts standardisation be measured by the level of process automation? What other indicators can be used?

Market participants believe that it would be inappropriate to analyse the degree of trade process automation or contractual standardisation in a quantitative way. Better then to ascertain progress achieved by the industry in making OTC market infrastructures increasingly robust by means of "indicators" (as in the Commission's question).

(3) Should non-standardised contracts face higher capital charges for operational risk?

Whilst central clearing of OTC Derivatives contracts should be possible in Europe in the near future, it would be overly simplistic to conclude that non-standard OTC contracts by default pose a greater operational risk thereby justifying higher capital charges. It should be noted that participants in the OTC market have natural incentives to act in a diligent and orderly fashion towards each other.

Additional capital penalties could easily drive business away from Europe's OTC space rather than from the OTC space to central market infrastructures. Therefore, efforts to recalibrate the operational risk regime must be conducted within a general review of the regime's appropriateness with regard to counterparty risk in general, rather than as a one-off exercise to address OTC derivatives risk only.

(4) What other incentives toward standardisation could be used, especially for non-credit institutions?

It would be inappropriate for standardisation to be subject to any regulatory, promotional intervention. The absence of incentives has not prevented the derivatives industry from making huge advances in improving the infrastructure that supports OTC markets.

Instead, the Dutch market supports the European consensus position of the banks as expressed by the EBF on this point. That is, it would be preferable to concentrate on the assessment on the possible provision of incentives in two policy areas that are instrumental to achieving the objective of financial stability: (i) strengthening counterparty credit risk mitigation and (ii) increasing transparency. Standardisation is best left to market forces and progress in that direction should remain to be founded on commercial reasons and, hence, free from any regulatory intervention.

Central data repository

The establishment of central data repositories is functionally complimentary to the establishment of CCP clearing for Derivatives, which we generally support. If there are CCPs clearing Derivatives contracts in Europe, it would be logical to set up a central data repository in Europe, subjecting it to European law and supervisory oversight. A comparable information flow to that generated by the DTCC Trade Information Warehouse in the United States for example is necessary and desirable in Europe to assuage supervisors' concerns over firms' exposures to Derivatives contracts and the wider implications that might have for macro-economic stability. A European central data repository should furthermore be overseen by a central European Supervisory Authority, such as the proposed European Securities Authority, going forward, in view of its central role in the wider European financial market.

(9) Are there market segments for which a central data repository is not necessary or desirable?

The Dutch market would support a risk based approach to data capture by a central repository. In other words, the more liquid and more standardised portions of those market segments should be captured first, i.e. CDS, interest rate swaps, commodity futures and/or foreign exchange trades.

(10) Which regulatory requirements should central data repositories be subject to?

Since the primary objective of setting up central trade repositories would be to enhance transparency around position-taking in derivatives, they should be requested to make market data on counterparties' trades and positions available on a systematic, regular basis to the relevant competent authority.
Existing reporting processes – using existing providers of portfolio reconciliations and compressing functions – should be utilised, replacing existing regulatory reporting requirements rather than duplicating them.

(11) What information should be disclosed to the public?

Voluntary public disclosure of derivatives data made by trade repositories has been instrumental in bringing more clarity to the market's true risk exposure to credit events, hence reducing uncertainty and, with it, the risk of financial instability. However, if trade depositaries formalise their interactions with supervisory authorities, the expectation would be that the latter take on the task via the public disclosure of the appropriate aggregated information.

CCP clearing

CCP clearing is the policy of choice for legislators and regulators in Europe and the United States. Whilst the Dutch market supports introducing CCPs to the derivatives space, it should be noted that there are downsides to CCP clearing just as there are advantages - these are not adequately explained in recent Commission material on the subject. Moreover, if the Lehman default proved anything it was that CDS contracts in times of a default can be unwound in an orderly and efficient way in an OTC context by employing the ISDA Framework amongst others. That said, it is well understood why CCPs are the policy option of choice for the authorities, not least because they provide for greater information capture as well as the more structured mitigation of risk.

(12) Do you agree that the eligibility of contracts should be left to CCPs? Which governance arrangements might be necessary for this decision to be left to the CCPs' risk committees?

Yes. The CCPs should have jurisdiction over which trades they feel most comfortable admitting to clearing. The CCPs should in a second stage consult with their members as to their proposals for eligibility. In a third stage, the CCPs and their members would present their proposals for approval by the relevant competent authority. The relevant competent authority ought to be obliged to respond to the CCP in a timely fashion and be transparent in its reasoning as to why certain trades may not be eligible for CCP clearing. Those trades not eligible for OTC clearing would by default be settled over the counter.

(13) What additional benefits should the CCP provide to secure a broader use of its services?

By way of principle, the CCP ought to be responsive to user demand and incorporate users fully and openly in its decision making processes. Functionally and ideally, a CCP would offer a multicurrency environment in which to clear trades (i.e. at least EUR and USD and where possible GBP, CHF and JPY) and in time offer the possibility of clearing CDS and other eligible Derivatives contracts.

(14) Is the zero-risk weighting a sufficiently effective incentive for using CCPs across different market segments?

Yes. The Dutch market believes that a zero percent risk weighting derivatives contracts cleared through a CCPs is a sufficiently powerful incentive for using CCPs, particularly in a context where regulatory capital – as a result of foreseen increased levels of capital (i.e. Commission's proposal on the capital requirements applied to the trading book) - is bound to become increasingly expensive.

(16) Should bilateral clearing of CCP-eligible CDS be penalised and, if so, to what extent? Is there a need to extend regulatory incentives to clear through a CCP to other derivatives products?

Such a process requires careful handling as there may always be legitimate risk management reason not to clear eligible trades through CCPs. Market participants should have the opportunity to explain why this is so before additional regulatory penalties are considered. A "comply or explain" mechanism may be helpful in this circumstance therefore.

(17) Under which conditions should exemptions be granted and by whom?

Exceptions should be granted ultimately by the CCP but in close cooperation with the relevant competent authority. The CCP should by rights understand the reasons why or why not it is accepting the trades for central clearing. Supervisory authorities have to be involved however to uphold wider systemic risk concerns.

(20) How could European legislation help ensuring safety, soundness and a level playing field between CCPs?

Market participants would welcome certainty that their business transactions will not be held to conflicting standards of conduct. Legal certainty has also an international dimension, in consideration of the global nature of OTC markets. The Commission should therefore continue working with international regulators and all with international standards setters to put in place consistent and convergent regulatory regimes across jurisdictions.

Transparency requirements

(21) Should MiFID-type pre- and post-trade transparency rules be extended to non-equities products? Are there other means to ensure transparency?

We reiterate that the lack of a formal transparency framework for non-equities products does not necessarily hamper market functioning as, in practice, investors in those products find dealer quotes of much more relevance than past price and volume data. Furthermore, since MiFID was designed for the equities markets, which differ considerably in form and function from derivatives markets, MiFID style rules could not be easily adapted to the very different OTC derivatives market space.

(22) How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?

Meaningful reporting is key to avoid unnecessary administrative burden for both regulators and the industry. Reporting tools must be suitable for regulators' own systems, and in turn for these systems to be capable of handling the data. Hence, it is paramount that attention is focused on effective regulatory needs.

Public trading venues

(24) How can further trade flow be channeled through transparent and efficient trading venues? What would be the appropriate level of transparency (price, transaction, position) for the different derivatives markets?

We reject the Commission's hypothesis that trading OTC Derivatives on exchange is overall necessary and desirable - the Commission's question would be better phrased as "what would be the relative merits of moving towards greater exchange trading of derivatives contracts?"

It is true that standardised futures contracts for example can be readily traded on exchange given their highly commoditised format and therefore susceptibility to standardisation. However, for contracts such as CDS, the purpose of which is after all to gain protection against specific risks at specific times by writing bespoke contracts, a wholesale shift to exchange trading would result in one of two scenarios – inefficient risk management within Europe or the migration of business to other jurisdictions outside of Europe. Most likely both scenarios would come into play at the same time, for the following reasons:

- first, exchanges are complementary to the OTC markets. Exchanges specialise in highly standardised products whereas many of the products currently traded OTC are either highly customised (e.g. single name CDS) or else only semi-standardised (such as index CDS). It is highly unlikely that single name CDS could ever be safely traded on a regulated market;

- second, Dutch bankers, like many of their other European counterparts, believe strongly that shifting OTC products onto exchanges would have a very serious impact on their ability to trade these products. Absent the participation of intermediaries and non-hedgers, CDS will cease to trade in a market and they will become extremely illiquid and costly, both to enter into and to terminate. This would produce serious negative implications for lenders, investors, companies and eventually the banks themselves as the cost of capital would rise whilst effective risk management would become more difficult;

- third, exchanges are designed to be accessible to retail as well as wholesale customers. The OTC derivatives markets are totally wholesale and it has been assumed, up until the recent crisis at least, that the wholesale customers are largely capable of taking care of themselves, hence the lighter level of regulation the markets have enjoyed. This is in line with the strategies of the major European securities excahnges which today offer a tightly regulated, retail focussed "regulated market" alongside "dark pools" of liquidity where wholesale investors can meet to trade large tickets or one-off trades with the necessary protection of delayed or reduced transparency; and

- fourth, the fact that the majority of European exchanges own their own clearing houses leads them to make the argument that in order to gain access to centralised clearing and settlement, products need to be listed on a public exchange. This is not the case. It has been possible for a long time for OTC products to be centrally cleared without being listed on a public exchange.

It can be concluded that it is possible to increase significantly the efficiency and transparency of the OTC markets without the products being listed on an exchange. Indeed to list some of these products on a public exchange could have an extremely damaging effect on the OTC market and possibly even be damaging for the exchanges themselves.

Finally, in relation to the link the Commission makes between transparency and applying the MIFID rules, we of course respect the MiFID rules in this regard and it is right that a framework for fair competition exists for trading equities between regulated markets, MTFs and systematic internalisers. However, it is generally accepted that the MiFID rules were designed specifically with the equities markets in mind where trades are generally small tickets but high volume. A simple read across of MiFID rules to the derivatives space would therefore be inappropriate and damaging for efficient risk management. Better then to focus on harnessing the information captured by the central data repository and the CCPs to address regulatory concerns as regards the transparency surrounding Derivatives trades.

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