Association des Banques et Banquiers, Luxembourg
The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

ABBL – Luxembourg Bankers' Association response to the EU Commission:

Public Consultation on Derivatives and Market Infrastructures

ABBL lobbyist registration number: 3505006282-58

Key Points

- *In principle, the ABBL[i] is supportive of central clearing as a concept, but nevertheless warns that it may be difficult to translate a conceptual idea into practical reality in such a complex field without side effects. Furthermore, the ABBL has some difficulties determining the scope of entities and products that are to be subject to the future regulation.*
- *The clearing infrastructure should be at the centre of the process and thus should determine the type of contracts that it deems eligible, based on user requests. Forcing the clearing of products by ESMA does not appear to be the right option because it risks forcing the clearing of contracts that are not economically viable to clear or would create too important risks.*
- *ESMA should maintain, open to the public, a list of eligible contracts and of those pending approval.*
- *Third country firms may be eligible to CCP membership, but subject to two caveats: the risk profile of the CCP shall not be impacted and there must be a level playing field with EU firms including their access to 3rd countries' CCPs.*
- *A major consideration for requiring the use of CCPs is systemic risk control. The ESRB shall thus be in the supervisory loop and a proportionality criteria should be introduced so that occasional or low risk firms, financial or not, may not be forced to be members of a CCP or to post important amounts of collateral.*
- *As market infrastructures, CCPs shall have robust governance, which consists of a strong risk management process, but also involvement of users/shareholders at every stage to better align the CCP functions with the market needs/realities.*
- *Interoperability is a necessity but should be tied to 2 conditionalities: first, it shouldn't increase the overall systemic risk and, secondly, it should be submitted to user support (i.e. prior approval). Furthermore, conceptually, the ABBL has some doubts that interoperability could be extended outright from cash instruments to derivatives.*
- *Trade repositories (TR) and reporting of transactions to these TRs may complete the framework and should be extended to non-cleared instruments.*

1 Preliminary remarks

The ABBL would like to complement its views with a recent paper from the European Banking Federation (EBF) (attached), which provides the views of the European commercial banking community on over-the-counter (OTC) derivatives and their market infrastructures.

Although central clearing may be very appealing, the ABBL would like to remind the EU Commission that costs to the users are likely to be considerable. A recent IMF/BIS paper estimated the costs at some $150 billion[1]. Thus, the ABBL is keen to see the impact assessment that will accompany any formal legislative proposal.

Today, not every Member State or market has a clearing house. This illustrates the intrinsic cross-border nature of the proposal and the accompanying legal and supervisory complexity.

To be pragmatic, the ABBL would welcome some clarification as to how current CCPs will be requested to handle current contracts, financial instruments and the existing regulations requirements. A grandfathering may be needed.

2 Clearing and risk mitigation of OTC derivatives

What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivate contracts for mandatory clearing, and its application? Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

The ABBL supports the concept of central clearing of OTC derivatives contracts. However, empirically, even if the past failures of large institutions have proved a difficult process, there has been no real impact from post-trade operations on the markets. Thus, one may question the need for mandatory central clearing, even if this is implied by the statement of the September 2009 G20 meeting[2]. Managing risk, is, in the ABBL's view, a 4 step process that starts with:

[1] Global Financial Stability Report "Meeting New Challenges to Stability and Building a Safer System" April 2010.
See at: http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/chap3.pdf

[2] The previous G20 meeting, in April 2009 in London, did not call for mandatory clearing but instead for "*the promotion of the standardisation and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision*". See at: www.londonsummit.gov.uk/resources/en/PDF/annex-strengthening-fin-sysm

1. proper corporate governance and effective supervision to address counterparty risk issues, mostly in OTC derivatives markets,
2. strengthening of collateralisation in bilateral clearing,
3. maintenance of capital incentives for central clearing of OTC contracts,
4. market-driven central counterparty clearing,

All these measures are complementary and should help manage systemic risks.

The risks with a regulation in this field is that it may have adverse effects, as it is likely to force the concentration on a few central counterparties. This may turn into a limited competition or oligopoly and in the end increase systemic risk in case of the failure of one entity. Overnight, many contracts would no longer be clearable and users would risk having to support failing CCPs, which would likely create liquidity stress.

The underlying concept of the recourse to CCPs, beyond the systemic risk management, should also relate to the preservation of market liquidity. In today's financial world, liquidity is a major driver and presents a real stress when it dries up. Thus, the ABBL would advise to take a careful approach when determining eligible contracts. Although the top-down/bottom-up approach combination may be a sensible concept in terms of day-to-day business, the ABBL believes that priority shall be given to a dual process whereby CCPs propose contracts for eligibility based on a user survey/demand. The relevant authority in coordination with ESMA should then validate this. Otherwise the imposition of a clearing obligation upon market participants may result in:

- CCPs, as well as their members/shareholders, being unwillingly exposed to undesired risks/business (unless they are able to refuse some trades even if theoretically eligible).
- CCPs may, as an alternative, refrain participants to undertake some transactions by imposing punitive requirements that, in a second instance, would reduce the hedging ability of their members.
- Finally, market authorities may be willing to impose drastic collateral obligations, which would make clearing economically unviable in the EU.

In other words, and to be pragmatic, no clearing obligation should be imposed upon OTC derivatives contracts' counterparties if no market infrastructure is economically and technically able to take on the additional exposure without increasing systemic risk.

The Association supports the EBF six steps to determine which contracts may be eligible to central clearing:

1. *ESMA can only determine that a clearing obligation exists for any given derivative contract if a request to establish such determination comes from a CCP clearing such a contract. ESMA should not have the authority to establish a clearing obligation on a contract if there is no connected request from a CCP.*

2. *Any request from the CCP to ESMA to determine that a clearing obligation exists for any given derivative contract, should have been favourably advised by the CCP's Risk Committee.*

3. *The assessment by ESMA of whether a clearing obligation exists for any given derivative contract should be taken on the basis of strict, public, and objective criteria. The set of assessment criteria will be subject to public consultation before being approved. The set will contain - at least - a criterion related to the reduction of systemic risk that mandatory clearing of any given contract would achieve; and another one looking at whether a similar obligation has been imposed in other relevant jurisdictions, so as to ensure global coordination.*

4. *ESMA's assessment to determine a clearing obligation for a specific contract should itself be subject to public consultation. Given the interest to calibrate the appropriate measures in accordance with the industry and end-users expectations, the 6 month period envisaged by ESMA to arrive at a decision should begin once all the responses to the public consultation have been received. ESMA can only produce a positive assessment in the absence of possible vetoes from EBA or the ESRB.*

5. *It should be avoided that the process to determine an obligation to clear eventually incentivises competition among CCPs on risk management grounds. For that reason, when the assessment process described above is negative or a veto exists, ESMA should list the instrument as one where no obligation to clear it centrally exists (i.e. negative list). Additionally, ESMA should allow for a de-listing of products upon which a clearing obligation has been established should the reasons that resulted in a positive assessment cease to exist.*

6. *The application of a clearing obligation to third country firms should be agreed internationally. An exception should be granted to intra-group transactions and thus also to transactions which only serve the purpose to transfer risks within a group (within the meaning of the directive 2000/12/EC - Banking Directive - and thus subject to supervision on a consolidated basis) to the other group entities in order to allow a more efficient risk management (which as purely internal transactions do not increase the overall risk exposure of the relevant banking group and thus have no impact on the systemic risk)[3].*

[3] A clearing obligation for such transactions would greatly diminish the efficiency of the risk management of a group. It should thus be considered to expressly clarify that intra group transactions (in case of banking groups subject to supervision on a consolidated basis and under the condition that all these transactions are integrated into the groups risk management system) would not fall within the ambit of the clearing obligation.

Concretely, even if a contract fulfils the six criteria, market participants and the infrastructure may need some time to comply and "clear the stock" of outstanding positions. Necessary time shall be allowed for CCPs to offer clearing and users to switch their positions onto a central platform. A grandfathering period is a must. In addition, ESMA members should also announce contracts that may become eligible well in advance.

The ABBL considers that CCP access should be non-discriminatory. Thus, market participants that are eligible should be given access on a fair basis. As to the question whether trading venues shall be granted access to CCPs, the ABBL's approach is to say yes, since otherwise this would create a imbalance between counterparties and markets, where some may be forced to a CCP and other not (with capital penalisation). In addition, for the moment there seems to be very few market places where other instruments than cash instruments would be readily eligible.

Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?

Yes. The clearing threshold should be set so that non-financial counterparties are not unduly burdened. The ABBL would even plead further that the thresholds also apply for financial institutions that are below it (proportionality criterion). Application and respect of these thresholds is another story, as it is not very clear at this stage who is going to check if they are respected or not.

The ABBL would invite the EU Commission to consider one exception to the regime for intra-group trades. Otherwise at group level institutions will be subject to double collateral requirement on each side of the trade (position may be netted or cancelled in case of failure of the group).

Do stakeholders share the principle and requirements set out above on the risk mitigation techniques for bilateral OTC derivative contracts?

The ABBL agrees in principle with the EU Commission proposal as currently formulated, but would like to point out that beyond forcing the recourse to CCPs, complementary measures may by themselves already mitigate risks and consequently shall be also supported i.e. close-out netting and the collateralisation of derivative contracts or portfolio compression. Regarding non-financial institutions, more types of collateral should be made eligible, such as physical collateral, e.g. plants and machines. The requirement to mark to market is a good general approach, but for some more exotic products marking to model may be the only available option.

3 Requirements for central counterparties

Do stakeholders share the general approach set out above on organisational requirements for CCPs? In particular comments are sought on the role and function of the Risk Committee; whether the governance arrangements and the specific requirements are sufficient to prevent and manage potential conflicts of interest; stringent outsourcing requirements; and participation and transparency requirements?

Current high level principles are agreeable. The ABBL would like to stress that the role of CCP members is key in the understanding and approach to risk management. Thus, the Risk Committee should include qualified users/stakeholders and have determining powers with regards to strategic decisions that the CCP may take. In the end, users may be the ones that will intervene to support a failing CCP (via a default fund). It is difficult to imagine a CCP regularly taking decisions against the opinion of its Risk Committee.

In addition, the role of users in this Risk Committee is important as they may decide whether to clear any (derivatives) product and how to manage the default of one of their peers. For infrastructure at least, decision-making and risk management are intrinsically linked.

As regards outsourcing, the Association shares the views of the EU Commission that critical and core functions of a CCP (clearing, risk management, etc.) should not be outsourced, unless it is within a same group. The ABBL nevertheless would like to have some clarifications at this stage on the interoperability and the scope of products covered by the future legislation, if any, as one can imagine that some CCPs will concentrate on specific segments of the market and thus need agreement/cooperation with others to complete their service offer.

Obviously, criteria to access CCPs shall be non-discriminatory, transparent and objective. This does not, however, mean that all contract details between a CCP and a member shall be disclosed.

In line with the current Code of Conduct (albeit for equities), the ABBL agrees that a CCP should publicly disclose information on fees and prices associated with its services in order to ensure greater transparency, better comparability as well as non-discrimination with a view to offering users the most objective basis for comparing available offers. On the other hand, risk management models shall not necessarily be made public, as they are a core feature of the commercial offer of the CCP. They may nevertheless be disclosed to supervisors and, on a bilateral basis, with members.

Do stakeholders consider that possible conflicts of interests would justify specific rules on the ownership of CCPs? If so, which kind of rules?

Strongly no. The ABBL is convinced that in the case of market infrastructures, the involvement of market stakeholders is key. This must be subject to some practical governance rules to manage potential conflicts of interests, but these shall remain feasible and to the benefit of both parties, CCPs and the user community. Therefore, the ABBL does not support a restriction on shareholders and would, on the contrary, invite CCPs to have an open structure, be it in their capital or in any other form, as this would better align the proposed services with market needs.

To conclude, there isn't necessarily an optimal ownership structure, but, in any case, conflicts of interests are manageable. The ideal structure is one where members are involved and able to influence key decisions be it via capital or another method.

Do stakeholders share the approach set out above on segregation and portability?

Technical details of the legislative proposal should first be disclosed, so as to be able to take a definitive position. However, as a principle, different products may require different treatments. Specifically, cash instruments may be difficult to segregate outright, as the number of transactions may be excessively high. This would turn into an operational challenge should they be segregated. Furthermore, segregation will limit the possibilities of prior netting of transactions, thus indirectly increasing risks.

The ABBL believes that such requirements may be left to commercial offers or CCP models depending on the type of products or market needs. What is essential, on the contrary, is segregation of clients' assets from own accounts at member level.

Do stakeholders share the general approach set out above on prudential requirements for CCPs? In particular: what should be the adequate level of initial capital? Are exposures of CCPs appropriately measured and managed? Should the default fund be mandatory and what risks should it cover? Should the rank of the different lines of defence of a CCP be specified? Will the collateral requirements and investment policy ensure that CCPs will not be exposed to external risks? Will the provisions ensure the correct management of a default situation? Are the provisions above sufficient to ensure access to central bank liquidity without compromising central banks' independence?

The key is that CCPs must have robust governance arrangements in place to ensure that they operate on a sound and safe basis so that systemic risk is limited. As for other fields, transparency may be a key to assure users of the sustainability of the CCP. Thus, details of standards and prudential requirements shall ideally be disclosed or easily available.

Furthermore, CCPs should ideally be single-purpose infrastructures, given their risk taking nature, and they should consequently concentrate on their core functions, i.e. clearing and managing risk. CCPs should, as banks, have enough capital at their disposal to preserve their stability and efficiency in the long run and under various economic cycles. Their capital should thus be risk sensitive: the more risk they take, the higher the requirements.

The ABBL is of the opinion that the default fund should be mandatory. However, this should not be the only barrier of risk management. Appropriate margins vs. member exposures shall be the first risk mitigator against adverse market movements or failures. Recourse to a default fund should only be the fail-safe.

In principle, the ABBL agrees with the default waterfall procedure presented in the consultation, but, like the EBF, would propose to rank the defence barriers in the following way:

1) *margins of the defaulting clearing member;*
2) *default fund contribution of the defaulting member;*
3) *CCP's own funds;*
4) *default fund and other contributions of the non-defaulting clearing members.*

CCPs may be left to draw the specific details of the plan, but in the ABBL's view, the sequence is very clear: each level shall be "emptied" before going to the next protection level.

Concretely, regarding margining, minimum thresholds should be set so that the collateral is of sufficient quality, but at the same time, CCPs should not require only the highest quality collateral to the detriment of other operations. It should be composed of an appropriate mix of instruments to meet margins and funds requirements. With a view to increasing the reliability of the CCPs in case of extreme stress, the ABBL considers that they may be granted access to central bank money, but not at the expense of other risk mitigation measures.

Do stakeholders share the general approach set out above on the recognition of third country CCPs? Are the suggested criteria sufficient? Do stakeholders consider that additional criteria should be considered? Do stakeholders agree with the extension of the clearing obligation to contracts cleared by third country CCPs to ensure global consistency?

Yes, if equivalence of rules and other requirements is ensured. What should be avoided is a double clearance whereby a EU counterparty trading with a US one, for example, has to clear its transaction on each side of the Atlantic.

The question relates to the extraterritoriality of rules and the differences that may arise if some products are eligible in the EU and not in third countries. But here more details may be needed, as well as some cooperation between authorities.

4 Interoperability

Stakeholders' views are welcomed on the general approach set out above on interoperability and the principles and requirements on managing risks and approval.

Conceptually, interoperability is a good principle, but not necessarily adapted to all situations. As in the Code of Conduct, the ABBL sees opportunities for cash instruments where transactions are numerous as well as counterparties. But the Association has some doubts regarding derivatives instruments that are usually contracts, not instruments per se, and do not trade on a formalised market or platform. In the later case, it may prove extremely complex to set a web of interoperable agreements between CCPs. If it is not manageable for CCPs, it will in turn impact its members. The ABBL would thus opt for interoperability for cash securities only.

To prevent an overly complex web of links, the ABBL would recommend that interoperability agreements should be submitted and duly approved by a significant portion of members of a given CCP.

Furthermore, it is through interoperability that failure at one CCP may be transmitted to others. The Association invites the EU Commission to remain prudent in the technical details of the model that it will draft.

5 Reporting obligation and requirements for trade repositories

What are stakeholders' preferred options on the reporting obligation and on how to ensure regulators' access to information with trade repositories? Please explain.

The view of the ABBL is that trade repositories may be a useful instrument to better apprehend the evolution of markets, including OTC markets. The Association would favour a reporting of all transactions to the TR by relevant market actors. But this should also be the only place where institutions have to report. Concretely, this shall replace any other form of reporting to avoid dual reporting to the maximum extent.

In the consultation, several issues remain unknown or unclear, including the frequency and content of reporting or what counterparty shall report in cases where none of them is a financial institution, as well as who may access these TRs. Reporting is costly and money should ideally be invested in real market improvements.

Trade repositories are by definition pure market infrastructures to help supervisors have access to information for the performance of their regulatory functions. At this stage, it may be that only one or two would be functioning at a global level. Although the ABBL would favour an European option, it believes that the market should decide as long as there is a guarantee that there is an exchange of information between the TRs and that they are open on a consistent and permanent basis in a timely manner to supervisory authorities from the EU, wherever located.

Do stakeholders share the general approach set out above on the requirements for trade repositories? In particular, are the specific requirements on operational reliability, safeguarding and recording and transparency and data availability sufficient to ensure the adequate function of trade repositories and the adequate protection of the data recorded?

Accuracy and integrity of the information are the 2 key criteria for TRs, and the current consultation principles seem to offer enough guarantees to meet these goals. Format for reporting shall be left to markets, although it makes sense to rely on common standards for other reportings (i.e. XBRL). Finally, some countries have specific data protection rules that shall be respected. Thus, appropriate procedures or the scope of information should be adapted.

6 Technical reference glossary of definitions

Do stakeholders agree with the definitions set out above?

The ABBL does not consider the definitions controversial at this stage.

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[i] *Concerning the ABBL:*

The Luxembourg Bankers' Association (ABBL) is the professional organisation representing the majority of banks and other financial intermediaries established in Luxembourg. Its purpose lies in defending and fostering the professional interests of its members. As such, it acts as the voice of the whole sector on various matters in both national and international organisations.

The ABBL counts amongst its members universal banks, covered bonds issuing banks, public banks, other professionals of the financial sector (PSF), financial service providers and ancillary service providers to the financial industry.

Association des Banques et Banquiers, Luxembourg
The Luxembourg Bankers' Association
Luxemburger Bankenvereinigung

ANNEX to ABBL's Response

Office address: ABBL asbl ▪ 59 boulevard Royal ▪ Postal address: P.O. Box 13, L-2010 Luxembourg
Tel.: (+352) 46 36 60-1 ▪ Fax: (+352) 46 09 21 ▪ mail@abbl.lu ▪ www.abbl.lu

EBF Ref: D0602E-2010
Brussels, 03 June 2010

Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.
The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

EBF's views on the upcoming European Commission's proposal for a Regulation on Market Infrastructures

Key Points

The EBF's general approach to post trading of securities and derivatives issues is based on four principles: (i) no single model approach for the evolution of post-trading in Europe; (ii) regulatory action to cement industry progress; (iii) regulatory action whilst ensuring efficient, secure, risk neutral, cost effective, innovative and inclusive of user governance solutions; and (iv) regulatory action on the basis of structured and regular dialogue with market infrastructures providers and its participants.

The EBF supports a combination of four measures to reduce counterparty risk in over-the-counter (OTC) markets: (i) market-driven Central Counterparty (CCP) clearing (ii) capital incentives for central clearing of OTC contracts; (iii) strengthening of collateralisation in bilateral clearing and (iv) proper corporate governance and effective supervision. Should the European Commission establish mandatory central clearing, the process should be informed by four principles, notably that the European Securities Markets Authority (ESMA) should not have the authority to establish a clearing obligation on a contract if there is no connected request from a CCP and that any such request must be approved by the CCP's Risk Committee.

The EBF stresses that CCPs must have robust governance arrangements in place and must ensure they operate on a sound and safe basis. CCPs shall take the appropriate actions to guarantee the permanent fulfilment of their obligations in order to reduce the sources of operational risk for them and for their participants. In this respect, the EBF believes that competition between CCPs should not be at the expense of proper risk management. Being risk takers by definition, CCPs should be single purpose entities which concentrate on their core business and must therefore have capital capable of preserving their stability.

European Banking Federation (a.i.s.b.l.)
10 Rue Montoyer B-1000 Brussels
T: 32 (0)2 508 37 11
http://www.ebf-fbe.eu

The EBF also calls for CCPs to have Risk Committees which shall be composed of participants and whose decisions must be binding. Finally, the EBF favours that authorisation to operate for CCPs should occur at European level while the supervision of CCPs should remain at domestic level.

The EBF is supportive of the establishment of Trade Repositories. Reported information to trade repositories should refer to all contracts traded in one (or several) segment(s) of the OTC derivatives markets, both centrally and non-centrally cleared. Trade repositories must ensure continuous and timely access to recorded information, notably to competent authorities. The decision on the establishment of a trade repository should be market-led. European trade repositories should be authorised and supervised by ESMA.

The EBF calls for a careful approach in defining the scope and the conditions for open access and interoperability between market infrastructures. In this respect, the EBF recalls that the regulators have recently recognised that interoperability could be a source of new systemic risk. Therefore, interoperability should be limited to cash securities.

Contact Persons:

Enrique Velazquez (e.velazquez@ebf-fbe.eu) and Christophe Bonte (c.bonte@ebf-fbe.eu)
Related documents:
EBF's response to European Commission's Consultation on "Possible initiatives to enhance the resilience of OTC derivatives markets
EBF's response to CESR Consultation on Trade Repositories

Preliminary remarks

1. The upcoming proposal for a European Market Infrastructures Regulation (i.e. EMIR) originates as a result of reflections over the adequacy of post-trading infrastructures for OTC derivatives in the context of the financial market turmoil. Whilst this paper mainly discusses market infrastructures for OTC derivatives, it should be recalled that the upcoming EMIR will regulate the post-trading space, irrespective of financial instrument or asset class. In that regard, the EBF states its general approach to post trading of securities and derivatives issues[i] based on the following **common four principles**:

   - **It is not possible to advocate for a single model approach for the evolution of post-trading in Europe**. Existing and profound variations across the asset classes, recommend tailored and flexible regulatory approaches to market infrastructures' legislation. Some provisions (in particular, in connection to risk management) need to be tailored by type of asset class.

   - **Public sector regulatory action should cement progress already made**. The market is proving its willingness and ability to restructure itself to provide what appear to be increasingly competitive services to participants (i.e. banks), which promote European integration and take into account the global dimension.

   - The **objective of public policy action should be to promote solutions** that are efficient, secure, risk neutral, cost effective, innovative and inclusive of user governance. Any policy action should preserve a level playing field on EU and global markets.

   - **Structured and regular dialogue between the market infrastructures' providers, users, and public policy officials** is proving its worth. This dialogue should continue to fashion consensual regulatory solutions that reward open and pro-European approaches and support smooth implementation of those solutions.

2. Unless otherwise stated, the EBF's detailed views on the upcoming EMIR are henceforth presented as those of the **users (i.e. banks) of post-trading infrastructures** (and associated services).

1. Clearing of OTC derivatives contracts

3. There is global regulatory consensus that, in order to reduce counterparty risk at the individual counterparty and systemic level in OTC derivatives markets, all eligible "standardised" OTC derivatives contracts should be cleared *via* central counterparties (CCPs). The EBF acknowledges the benefits of central-clearing for mitigating counterparty risk and is, therefore, supportive of extending the use of central clearing for as many OTC derivative contracts as possible. The EBF, nonetheless, considers that **the imposition of a mandatory central clearing obligation as a subset of the OTC derivatives' contracts (i.e. CCP eligible) has not been thoroughly weighted** against the operational and economic consequences of such a decision, and in light of other possible

alternatives that would deliver similar regulatory outcomes. And this for the following reasons:

- **Granting the European Securities Markets Authority (ESMA) authority to determine a clearing obligation may lead to operational and risk management challenges for a CCP and its members.** The European Commission is apparently considering to grant the ESMA the authority to determine what OTC contracts should be subject to a central clearing obligation. Such authority shall apparently exist irrespective of whether a CCP has applied to ESMA with a request for recognition of clearing eligibility. Such authority could ultimately result in the following:

  (i) if a CCP already offers clearing of the relevant products for a limited circle of users, making clearing of these products mandatory for all users may force any given CCP to accept more users and another quality of user that it considers appropriate or reasonable, with the risk that the CCP's risk management system may not be capable of handling such an extension of the user population;

  (ii) likewise, counterparties - that may have good reason to clear the relevant transactions bilaterally - could be forced to clear those transactions *via* a CCP, irrespective of risk-assessment considerations or economic costs.

- **Forcing central clearing of eligible standardised derivatives may endanger a safe, economically viable transition to CCP clearing**. If transition to CCP clearing is to proceed on a viable basis, it needs to happen in an efficient way. Transition costs for dealers (e.g. upfront initial margins, guarantee fund contributions) may be substantial (up to about $150 billion, according to the Bank for International Settlements' (BIS) and the International Monetary Fund' (IMF) staff estimates[ii]). The immediate pledging of potentially large amounts of collateral may be disruptive for the stability of the financial system as a whole and may eventually have an impact on the availability of credit to the real economy.

- **Imposing central clearing of OTC derivatives ignores the serious, ongoing efforts of the industry - underpinned, true, by an amount of regulatory pressure - to reform and to advance central clearing**. The industry has committed itself to ambitious targets for central clearing in various classes of OTC derivatives' contracts[iii]. Dealers' progress on central clearing within the boundaries of what it is possible (i.e. for CCP-eligible contracts) has been recently recognised by the Financial Stability Board[iv].

- **The regulatory push for central clearing may give rise to valid concerns over concentration risk at the level of the CCP.** Whilst the industry is committed to the use of CCPs as a systemic risk reduction tool, inappropriately forcing the concentration of the bilateral clearing space onto a few central platforms will increase the interconnection between clearing members. This could turn CCPs into institutions prone to moral hazard issues as they will become too big to fail.

- **Mandating the clearing of certain OTC derivatives contracts ignores and undermines existing incentives to use CCP to clear all derivative contracts**. According to the Capital Requirements Directive (CRD), regulatory counterpart credit risk capital requirements on centrally cleared transactions are currently zero[v]. This important capital relief provision will be further used by banks as a result of the expected tightening of concomitant capital requirements recently proposed by the Basel Committee[vi].

4. The EBF highlights that despite the explicitness of the September G20 statement on OTC derivatives' clearing, **the European Commission has already hinted that it could be flexible with regard to the imposition of the clearing obligation to corporate end–users** that do not become significant parties in the system of counterparty relations outside CCPs. The EBF agrees with the European Commission, that monitoring the extent to which an institution's default could harm other derivatives' users and the financial system overall, is the yardstick by which the appropriate management of any given institution's exposures should be determined.

5. As a result of the above, the EBF considers that while central clearing is clearly worthwhile for a lot of instruments, **it has not been proven that mandatory central clearing is able to improve the regulatory objective of reducing counterparty risk significantly. Indeed, it may even lead to negative consequences**. Therefore, in addition to market-driven CCP clearing for the reasons stated above, the EBF suggests a combination of the following:

   - **An analysis / review of the existing incentives in the capital framework and how these can facilitate the move of OTC derivatives' contracts from the bilateral clearing space to CCPs**. The Basel Committee has already proposed new rules that would require banks to set aside more capital against bilateral exposures, thereby creating an incentive to move bilateral OTC derivatives to central clearing[vii]. The EBF considers that any capital recalibration needs to take into account the interplays with other measures and the expected results of their combined effect. Notably, the EBF considers that, where risk mitigation achieved through bilateral collateralisation is comparable with central clearing, this should be reflected in the capital treatment of bilateral exposures. Capital charges should be calculated on the basis of a number of parameters, such as - but not restricted to - the collateral and netting arrangements in place, aimed at establishing the level of risk of the relevant transactions.

   - **Regulatory action to strengthen collateralisation in bilateral clearing**. The EBF agrees with the European Commission that bilateral collateralisation presents some weaknesses. However, instead of penalising bilateral clearing from a capital mobilising perspective, the EBF suggests a more engaging approach, with regulatory action being taken to improve techniques, such as close-out netting and collateral agreements, further. For example, legal certainty could be enhanced through adoption of a Netting Directive. There is no pan-European regulation which defines 'close-out' even though it is a cornerstone of derivative master agreements and is referred to in various EU Directives. In addition, there is considerable scope for different Member States' interpretations of aspects of the 2002 Financial Collateral Directive, and both sell- and buy-sides are engaging with each other and regulators with a view to

enhancing portfolio reconciliation practices and collateral dispute resolution procedures.

- **Proper corporate governance arrangements and effective supervision**. The resilience of the OTC derivatives markets can only be ensured if, in addition to better regulation delivering on the right regulatory outcomes, proper corporate governance and effective supervision are in place. Careful implementation of governance principles applicable to market participants can enhance the OTC derivatives counterparties' safety and soundness as well as the stability of the OTC derivatives' markets as a whole. Effective supervision should focus on evaluating risk management and governance of market participants in the OTC derivatives markets.

6. Despite the argumentation provided above, should the European Commission decide to grant the European Securities Markets Authority (ESMA) the authority to determine what OTC contracts should be subject to a central clearing obligation, the **European banking sector would like to request that such a process be organised in compliance with the following four principles**:

   - ESMA can only determine that a clearing obligation exists for any given derivative contract if a request to establish such determination comes from a CCP clearing such a contract. ESMA should not have the authority to establish a clearing obligation on a contract if there is no connected request from a CCP.

   - Any request from the CCP to ESMA to determine that a clearing obligation exists for any given derivative contract, must be approved by the CCP's Risk Committee.

   - The assessment by ESMA of whether a clearing obligation exists for any given derivative contract should be made on the basis of strict, public, and objective requirements, following an application made by a CCP. Global coordination here is highly desirable in order to avoid conflicts between counterparties from different jurisdictions.

   - If one CCP - on the basis of a decision made by the CCPs' Risk Committee - objectively rejects to clear a contract, this instrument should – after confirmation by ESMA – be deemed "not CCP-eligible". This will secure that no competition takes place between CCPs on risk management grounds and hence mitigates any additional potential systemic risk. ESMA should list "not CCP-eligible contracts", meaning that no other CCP can clear such contracts.

2. Central counterparties (CCPs)

7. As the margin and collateral will ultimately be posted by participants in the CCPs, these have a true interest in having efficient, sound, and safe infrastructures at their disposal. In that vein, the EBF would like to formulate some key principles that should govern the establishment and functioning of CCPs.

Organisational requirements

8. The EBF stresses that **CCPs must have robust governance arrangements in place and ensure they operate on a sound and safe basis.** As banks have an interest in understanding how a CCP is organised and in resting assured about the sustainability of the CCPs' high standards, those arrangements should be disclosed to (potential) participants.

9. As a market infrastructure, CCPs contain recorded trade data. Banks support that regulators and supervisors have unfettered access to detailed data recorded in CCPs (and in Trade Repositories). Consequently, **CCPs must accurately store information and grant regulators and supervisors unfettered access to it**. In doing so, CCPs must ensure **strict confidentiality of information** submitted to them.

Risk management

10. The EBF insists that CCPs shall take the appropriate actions (e.g. default arrangements) to **guarantee the permanent fulfilment of their obligations in order to reduce the sources of operational risks for them and for their participants.** In this respect, CCPs must establish **efficient contingency** plans. They should also be granted **access to central bank liquidity in exceptional circumstances.**

11. As a general principle, the **critical and core functions of a CCP** (clearing, risk management, etc.) **must not be outsourced**. Outsourcing between a CCP and a service provider belonging to the same group should be allowed as long as it fulfils strict conditions and does not result in a delegation of responsibilities by the CCP.

12. The EBF believes that **competition between CCPs should not be at the expense of proper risk management.** In this respect, CCPs are encouraged to improve risk management so as to achieve the highest standards. On the other hand, regulators should publicly disclose **minimum harmonised requirements for the risk model of a CCP**, so as to avoid competition between CCPs' risk models.

Transparency

13. A CCP shall **publicly disclose information on fees and prices** associated with its services, so as to ensure greater transparency and better comparability (through price simulation tools e.g.). **Risk management models and assumptions** are proprietary information that should primarily be disclosed to regulators, but also, if requested, to participants and participants applying for membership.

Minimum capital requirements

14. CCPs are single-purpose organisations which, by definition, are risk takers. Therefore, **CCPs must concentrate on their core business** (clearing, risk management). To this end, **CCPs must have capital capable of preserving their stability**. Minimum capital

requirements must be required prior to authorisation. Capital levels should be risk-sensitive.

Risk Committee

15. A CCP shall have a **Risk Committee comprising the CCPs' participants (including indirect participants)** but in a proportion that is commensurate to the risk derived from the possible failure of the CCP. Information over its governance arrangements and related procedures will be publicly available.

16. The **decisions of the Risk Committee within the remit of its competence** (e.g. the CCPs' risk management function, including possible requests to ESMA to determine that a clearing obligation exists for any given derivative contract) **must be binding for the CCP** because the clearing members bear the ultimate risk through their contributions. One lesson from the financial crisis is that the separation of decision-making and risk-bearing can be a source of problems.

Interfaces with relevant stakeholders

With participants

17. Participants meeting appropriate admission criteria and/or any other specific obligations will have **open access** (i.e. non discriminatory) to CCPs.

18. At the request of the participants, CCPs must be able to ensure efficient **segregation of assets and collateral from both their clearing members and their clearing members' clients**.

With shareholders

19. As a general principle, the EBF believes that **CCPs' ownership should not be an obstacle for the development of a competitive post-trading environment**. Competition authorities should be vigilant to avoid competition constraints. **No general restrictions** should apply as to the identity and holdings of possible CCPs' shareholders. Specific requirements (e.g. suitability, influence) or procedures (e.g. notifications, consultations) may, however, apply at the time of the authorisation or when the acquirer(s) reaches certain voting thresholds.

With regulators and supervisors

20. The EBF calls for the **supervision of CCPs to remain at domestic level**, notwithstanding the competence of the to-be-created European Supervisory Authorities (ESAs) to issue technical standards and align supervisory practices. In the absence of a European body or any cross-border fiscal burden-sharing arrangements for failing financial institutions, the fiscal responsibility in the event of a failure of a CCP continues to lie with the Member State in which the default CCP is situated.

21. Nonetheless, the EBF favours that the **CCPs' authorisation takes place at the European level** so as to avoid any possible discrepancy in the criteria applied in this process. Authorisation by ESMA would allow such authority to set up a list of CCPs that meet the relevant criteria and can consequently offer their clearing services on a European cross-border basis.

3. Trade Repositories (TRs)

22. The EBF agrees with the European Commission that **information for regulators on the aggregate view of the interconnectedness of positions held by market participants and the exposure to counterparties' derivatives' markets needs to be improved**. Consequently, the EBF agrees with the need to establish Trade Repositories (TRs).

23. In connection with these infrastructures, and from a user perspective, the EBF considers that:

- **Each trade repository should collect data on all contracts traded in one (or several) segment(s) of the OTC derivatives' markets, centrally and non-centrally cleared**. Reporting requirements to TRs should not duplicate existing transaction reporting requirements for OTC derivatives and recent moves by CESR to broaden those out.

- **TRs must ensure accuracy and integrity of the information recorded in their systems**. Formats for reporting information to trade repositories should be subject to market–driven, regulatory–promoted standardisation. It should be noted that a way around jurisdictional confidentiality requirements limiting the information that can be reported to TRs may need to be explored in order to ensure that all counterparties are able to report all necessary information.

- **TRs must ensure continuous and timely access to recorded information** to (i) regulators and supervisory authorities (i.e. unlimited access for the performance of their respective functions); and (ii) to the reporting entities and the entities on whose behalf the transactions are conducted (i.e. only on the relevant information concerning the reporting transaction). Trading Repository's authorisation should be on condition that such access is assured.

- **TRs can be instrumental in enhancing market transparency in the OTC derivatives' market**. Consequently, TRs should make information related to contracts registered with them publicly available on an appropriate time basis. To ensure that legitimate confidentiality concerns are addressed, information should be provided in an aggregated and anonymous fashion.

- **The decision on the establishment of a TR should be market-led**.

- TRs' **authorisation and day-to-day oversight** of TRs established in the EEA should be the competence of ESMA. ESMA should be adequately staffed to perform the function.

4. Interoperability

24. The EBF encourages the European authorities to **define common and comprehensive rules that would govern access and interoperability between market infrastructures where this is possible and needed**, with a view to offer further and tangible solutions across the asset classes and market infrastructures that are fit for Europe's increasingly global and competitive single financial market.

25. The EBF nevertheless believes that **the exact definition of the scope and the conditions for open access and interoperability between market infrastructures requires careful consideration.** Indeed, as recently recognised by the regulators, interoperability could be a source of new systemic risk if not carefully analysed and executed, owing to the 'contagion' effect on interconnected CCPs in the event of a failure of one or more of the CCPs participating in the interoperable arrangement. Therefore, the EBF considers that:

    - the scope of **interoperability should be limited to cash securities.** Being a more complex market, the EBF does not believe that derivatives should be included in interoperability arrangements;

    - in the event of the upcoming proposal favouring more interconnections between CCPs, the basis for interoperability requests would be **for a CCP to demonstrate significant user or customer demand,** before being allowed to enter into an interoperability arrangement with another CCP. Furthermore, there should be clear guidelines in place from regulators on the conditions to be met in order to allow interoperability, especially on risk, so that CCPs are not denying interoperability to competitors because they do not want to lose market shares. As an additional principle, **the costs incurred in developing interoperability links should not be recovered through increased clearing fees for customers that do not use the interoperability arrangements.**

    - Requests for interoperability based on an objective and consistent assessment of the effectiveness of competition will be difficult to achieve. There is currently no model or concept available to judge such effectiveness (unlike other industry sectors such as energy and telecommunications).

    - Mandating the granting of link requests and favouring unconditional access might have unwanted consequences, such as market paralysis due to excessive links, many of them being effectively useless or inactive. This approach **might furthermore increase the level of systemic risk and have unnecessary costs for users.**

26. CCPs must ensure that the terms for access and interoperability are **transparent for users** and that they can cope with the risks associated with the links they will operate. An **effective approval regime by the relevant European authority must be set up beforehand to assess the risks arising from an interoperability arrangement** and to prevent systemic risks that may affect users when a CCP enters into an interoperability arrangement with another CCP resulting in inter-CCP exposures.

Endnotes

[i] *See at EBF' The European Financial Market. The Banks' Overview of the Developments of the Single European Financial Market and Reflections on Upcoming Challenges (page 27).*

[ii] *Global Financial Stability Report "Meeting New Challenges to Stability and Building a Safer System" April 2010.*
See at: http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/chap3.pdf

[iii] *In a March 2010 letter[iii] to the Federal Reserve Bank of New York (FRBNY), 15 major OTC derivatives dealers set specific, enhanced target levels for expanding central clearing for OTC credit and interest rate derivatives. These commitments include, for example, central clearing of 95% of new clearing-eligible interest rate contracts trades, and 85% of historical eligible interest rate trades (calculated on a notional basis).*
See at: http://www.newyorkfed.org/newsevents/news/markets/2010/100301_table.pdf

[iv] *http://www.financialstabilityboard.org/publications/r_100419.pdf*

[v] *Annex III Part 2 para 6 of the Capital Requirements Directive.*
See at: http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf

[vi] *In the context of capital relief and the wider Basel-led discussion, the EBF supports that also indirect clearing members should face a zero-risk weighting when they have a direct claim on the CCP equivalent to that of a direct clearing member.*

[vii] *For each counterparty, there is a capital charge for the "bond equivalent" value of a stressed exposure at default (EAD). EAD calculates the net exposure of a derivatives portfolio over a one-year period, and provides a credit valuation, which is translated through a bank's profit and loss statement, when a counterparty's credit spreads widen. Regulators will now require banks to make the calculation over a three-year period, while also including a one-year stressed period. As a result the capital needed to be set against derivatives trading will be significantly higher. In addition, extra charges will be applied where a counterparty has more than 5,000 trades with another, the product is deemed more "complex" and where there has been a history of collateral disputes. In addition, banks will be required to hold yet more capital against their counterparty exposures. This is determined by using EAD as the principal amount of a bond and the counterparty's credit default swap spread as the discount rate. So the wider the credit spread of the counterparty, the more expensive it is to trade with.*