

ZENTRALER KREDITAUSSCHUSS

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Consultation of the European Commission on possible initiatives to enhance resilience of OTC derivatives markets – Consultation Document COM (2009) 332/ SEC (2009) 905 of 3 July 2009

Response of the Zentraler Kreditausschuss¹

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¹ The Zentraler Kreditausschuss (ZKA) is the joint committee operated by the central associations of the German banking industry. These associations are: Bundesverband der Deutschen Volksbanken und Raiffeisenbanken e.V. (BVR), Bundesverband deutscher Banken e.V. (BdB), Bundesverband Öffentlicher Banken Deutschlands e.V. (VÖB), Deutscher Sparkassen- und Giroverband e.V. (DSGV), Verband deutscher Pfandbriefbanken e.V. (vdp). Collectively, they represent around 2,200 banks.

I. General Remarks

The ZKA welcomes the opportunity to participate in the consultation of the European Commission concerning possible initiatives to enhance the resilience of OTC derivatives markets. It has been and continues to be supportive of all effective measures which help to enhance market resilience.

OTC derivatives are not just trading instruments. They are also an important means of diversifying and mitigating risks that institutions are exposed to in the course of their business activities. In particular Credit Default Swaps (CDS) are used by institutions for the purpose of protecting themselves against individual counterparty default risks. The Banking Directive (Directive 2006/48/EG) explicitly recognises the risk-mitigating effects of credit derivatives by permitting institutions, subject to certain requirements, to rely on the protection provided by CDS when calculating their capital requirements in respect of credit risks they are exposed to.

Efficient and resilient OTC derivatives markets are, however, not only important for institutions but also for the non-banking industry as well. The diversification and mitigation of risks is equally important for commercial and industrial entities, including small and medium sized entities, as it is for financial institutions. Consequently, commercial and industrial entities constitute a significant portion of the buyers of derivatives (“buy-side”). As these entities will also be affected by any new regulation of the derivatives markets, there is a certain level of concern over the impact the initiatives currently being considered by the European Union will have on them.

OTC derivatives markets are very diverse and the products differ greatly; in particular, a distinction has to be made between certain comparatively basic products (such as index based CDS) and products used for specific hedging purposes and in view of a specific risk exposures. Approaches and solutions meant to address systemic risks may be appropriate or useful in one area. They may, however be inappropriate or even counterproductive in other areas, in particular where individual solutions are a necessity.

Thus, the emphasis on product standardisation and CCP-clearing bears the clear risk of a fundamental conflict between the objectives pursued in relation to the OTC derivatives markets and the complex risk management model of the Banking Directive implementing Basel II. Customized derivatives serving as risk mitigation instruments which can be adjusted to a specific risk profile are an essential element in this regulatory risk management concept and their role within this framework cannot be taken over by standardised products. Likewise, any

new capital requirements meant to incentivise specific developments in the area of the OTC-derivative markets could severely upset the existing complex and finely balanced capital requirements framework.

In addition, the initiatives considered by the European Commission could also seriously impede the development of new products as these are necessarily not eligible for standardisation, central counterparty clearing (CCP-clearing) or exchange trading. Such an impediment to competitive structures cannot be in the interest of the European financial markets.

Against this background we can respond to the individual questions as follows:

II. Responses to the specific questions

• Promoting Further Standardisation

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

Standardisation should not be promoted for its own sake. Whether and, if so, to what extent standardisation may be useful and appropriate depends on whether standardisation serves the purposes it is meant to achieve in the relevant context. In particular, a clear distinction needs to be made between relatively plain and simple products and products developed specifically to address a certain risk.

In addition, when discussing the issue of standardisation, a further distinction has to be made between the following aspects:

- Standardisation of processes (e.g. transaction matching, confirmation and settlement).
- Standardisation of the products and their economic terms (e.g. underlyings, tenor, settlement features and other key factors such as day count fractions or business day conventions).
- Standardisation of the contractual documentation (e.g. master agreements, definition booklets, trade confirmations).

The term “contract standardisation” used in the consultation paper may therefore be misleading, as it can be understood to encompass a standardisation of the (contractual)

documentation. However, it follows from the context that the focus is rather on the standardisation of the processes², specifically the use of electronic tools for matching, confirmation and settlement of transactions, and products.

As regards the standardisation of these aspects, namely the standardisation of processes, products and the contractual documentation, we would like to take the opportunity to point out the following:

a) Standardisation of processes

The industry has been improving confirmation practices and other aspects of transaction processing continuously. Considerable progress has been made in this area³ and the industry remains committed to further optimizing transaction processing. This of course encompasses the expansion of the use of electronic means, especially for confirmation purposes. In fact, electronic confirmation systems already play a very important role and improved systems and applications are continuously being developed. In many areas electronic confirmation has already become the industry standard and it can be expected that electronic processing applications will become more and more prevalent in other areas as well. The banking industry thus shares the view of the European Commission that electronic means should be used wherever appropriate and useful in order to increase overall efficiency and reliability of transaction processing.

Nevertheless, in some areas or for some market participants non-electronic means, for example oral (by telephone) or written (by fax etc.) confirmations, are still commonplace. One reason is that the implementation of electronic confirmation processes requires considerable investments in infrastructure (both hardware and software). Such investments may simply not be merited where the number of transactions executed by the relevant party is comparatively low and the available alternative means are sufficiently reliable and efficient: Electronic processing is only a viable option, where the transaction volume is sufficiently high. Where a certain threshold is not surpassed or for smaller or medium-sized entities the necessary investments in infrastructure may not be merited. In this context, it needs to be considered that the electronic systems on offer can only be applied to one specific product class so that institutions are actually confronted with the decision to invest in more than one electronic infrastructure in

² To avoid any confusion, we will therefore in the following use the term “transaction” instead of “contract” where reference is made to the individual transaction (or trade) between counterparties involving a derivative product.

³ For example, in respect of credit derivatives, about 90% of the transaction volume is being matched electronically with the assistance of DTCC services. Another example of a widely used electronic service is TriOptima.

order to introduce electronic processing for a wider selection of products. An obligation to use electronic means in all transactions, without exceptions or minimum thresholds could therefore exclude some institutions from market access or at least significantly affect their competitiveness.

Likewise, electronic processing cannot be used for all aspects of a transaction where the relevant counterparty does not possess the infrastructure to use electronic confirmation processes. This may not be uncommon in derivative transactions where the counterparty is not itself a financial institution or in the case of small or medium-sized entities with a comparatively low trade volume, for example a medium sized automotive components producer requiring a foreign exchange derivative in order to hedge foreign exchange risks in relation to its export activities. Even larger commercial or industrial entities may not be connected to the relevant infrastructure.

A certain amount of non-electronic transaction processing can therefore not be avoided. However, this does not cause specific systemic risks which cannot be addressed adequately through implementation of appropriate measures and controls safeguarding a sufficiently high level of reliability and efficiency.

Taking into account the general level of electronic processing achieved so far and the existing common interest in expanding the use of electronic means wherever practical, there appears to be no need for further regulatory measures or incentives to promote further use of electronic means for the processing of transactions.

b) Standardisation of products

It will not be possible to standardise all derivative products to such an extent that all of them become eligible for CCP-clearing (let alone for trading on regulated markets) nor would this be desirable or necessary in order to attain the objectives pursued, namely enhancing resilience and efficiency of the derivatives markets.

Derivatives are important instruments for the diversification and mitigation of risks that institutions and non-banking entities are exposed to in the course of their business activities. They have to conform to individual risk portfolios and therefore have to be amenable to individual or bespoke solutions. For example, the treasurer of an automotive components producer who requires a hedging instrument for the specific foreign exchange risk associated

with the company's export activities cannot rely on standardised currency pairs or maturities not matching the specific cash flows. In this context, it is of no consequence or value to the relevant company that the available standardised transactions are cleared through a central counterparty and thus are potentially more secure than a non-standardised product not eligible for CCP clearing. In addition, standardised transactions which do not fully map the underlying transaction might also be ineligible for hedge accounting under the applicable accounting rules (e.g., under IFRS). Likewise, an institution extending a customised loan instrument to one of its corporate clients would ideally rely on specifically adapted derivative hedges to protect itself in the most effective and efficient manner against the relevant counterparty risk. Standardised derivatives will not conform in all respects to the relevant risk profile and can thus not be used as effectively and efficiently as customised (and thus necessarily non-standardised) derivatives. Consequently, additional risk mitigation instruments will need to be applied, increasing costs for the relevant institution.

This risk mitigation functionality of derivatives is also addressed in the Banking Directive (Directive 2006/48/EG). It specifically provides that institutions, when calculating their capital requirements, may take into account credit risk mitigation achieved under a credit derivative transaction, provided that the derivative in question meets certain requirements. In fact, the Banking Directive relies to a great extent on the availability of OTC derivatives as highly flexible risk mitigation instruments. Standardised derivatives necessarily lack the requisite flexibility and are thus not equally qualified as risk mitigation instruments as non-standardised derivatives. Consequently, an extensive standardisation of derivative products in the interest of reducing systemic risks ultimately conflicts with the role the Banking Directive allocates to derivatives as risk mitigation instruments. It would ultimately affect the efficiency of risk mitigation models of institutions and their customers and it would also at least indirectly induce the standardisation of other non-standardised financial products which rely on the availability of derivatives a risk mitigating instruments to the detriment of the competitiveness and stability of the European financial markets and, also, the customers.

Moreover, the recent experience with the standardisation of certain types of CDS in order to enable CCP clearing has demonstrated that any attempt at product standardisation raises a number of complex practical issues. Standardisation, even if restricted to specific products, is a challenging process requiring a considerable coordination effort involving all concerned parties.

Furthermore, standardisation is only possible with regard to sufficiently established products whereas new products necessarily cannot be standardised until they have been on the market

for a certain amount of time and until the volume of trades has reached a certain level. Forced standardisation would therefore impede product innovation and lead to static, uncompetitive market structures. This also cannot be in the interest of the European financial markets, both from the perspective of the market participants and the regulatory authorities.

c) Standardisation of the contractual documentation

The contractual documentation used for derivative transactions is already standardised for the vast majority of transactions and products: The parties almost always rely on standard master agreements developed by international trade associations such as the ISDA Master Agreements or the German Master Agreement for Derivative Transactions or the European Master Agreement (EMA) as well as on standardised terms and conditions or sample confirmations for various derivative products. Thus, as regards the contractual documentation for derivative transactions, there is no need for further standardisation beyond the already ongoing industry initiatives to further develop the documentation in line with the natural evolution of the markets.

However, a need for further “standardisation” does exist with regard to the national laws of the EU member states as well as on the international level: Further harmonisation of the national laws would greatly help to reduce existing legal uncertainty as regards the validity and enforceability of the master agreements, and in particular, the netting provisions contained therein, under the various jurisdictions. The same applies correspondingly to the national laws governing the posting of and the rights in collateral. Recent revisions of the legal framework of the EU failed to address many of the concerns raised by the banking industry in this respect. In addition, at least in some jurisdictions, the existing directives harmonising certain aspects of the legal framework, for example the Financial Collateral Directive (Directive 2002/47/EC as amended by Directive 2009/44/EC) have either not been fully implemented or exceptions apply which greatly diminish the harmonising effect of the relevant directives. A new initiative to improve the overall state of the harmonisation of the laws in respect of netting arrangements and collateral would therefore be welcome.

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

The level of automation of processes cannot and should not be the only measure to assess the level of standardisation of transaction processing or, even more pertinently, its efficiency (again we imply from the context that the question primarily refers to standardisation of processes as opposed to standardisation of products and the contractual documentation).

Other important indicators to assess the reliability and efficiency of transaction processing (which incidentally apply to electronic as well as non-electronic processing) are

- the time elapsing between the initiation of a transaction and the execution (acceptance and confirmation of terms by the parties), and in the case of CCP clearing, the time elapsing between the initial transaction (including the mapping of the transaction details) and the novation of the transaction by the CCP (T+x),
- the transaction volume (number of trades processed per product class and day),
- the measures implemented to manage and process lifecycle events etc. (such as corporate actions or credit events), and
- the percentage of erroneous or incomplete confirmations.

The degree of electronic processing can therefore be no more than only one indicator among many to assess the overall reliability and efficiency of transaction processes.

As to the different aspects of standardisation that need to be distinguished and the limits of standardisations as a means to reduce systemic risks, see above.

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

No. For one, the question presupposes that the use of non-standardised products automatically increases operational risks. This is not the case. Non-standardised products are not inherently more risky than standardised ones. Moreover, any additional operational risks associated with the use of non-standardised products, if any, should be reflected in the capital charge institutions have to calculate for their operational risks. It cannot be in the interest of efficient risk mitigation strategies to commingle operational and credit risks and ignore the differences between these two distinct risk categories. This, however, would be the case if an additional capital charge were to apply to credit or market risks because of potentially higher operational risks. Additional capital requirements introduced to incentivise CCP clearing would therefore severely upset the finely balanced and highly complex capital requirements framework of the Banking Directive. In particular financial institutions which already reflect the issue of the lack of standardisation in their operational risk models would either be punished by such additional capital charge or would be forced to adapt and simplify their operational risk model in order to

take into account the standardised additional capital charge in relation to the same operational risks.

Furthermore, for the reasons stated in our general remarks and in our response to question 1, it will never be possible to standardise all aspects of derivative transactions nor across all product classes. Derivatives which are used for hedging purposes (by financial institutions themselves or commercial and industrial entities) must be adjustable so that they can be structured to conform to the specific risk portfolio. They thus cannot be standardised or replaced by standardised products without losing their effectiveness as hedging instrument or without affecting the ability to obtain preferred accounting treatment because of their use (e.g. fair value accounting instead of hedge accounting). Thus, to introduce an additional capital charge for non-standardised derivatives would effectively penalise the use of effective risk mitigation instruments. This would be clearly counterproductive as it would only encourage reliance on less risk specific and less effective risk mitigation tools.

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

We believe that the existing incentives to use CCP-clearing of eligible OTC derivatives are already sufficient. As regards the standardisation of processes, the far reaching developments achieved in this area within a relatively short time demonstrate that there is no practical need for further incentives: standardisation comes naturally with the evolution of the markets. The same applies correspondingly to the standardisation of the contractual framework (see above).

- **Strengthening Bilateral Collateral Management for Non-CCP Eligible OTC Derivatives**

(5) How could the coverage of collateralised credit exposures be improved?

The question presupposes that a significant portion of the overall credit exposure from derivative transactions is currently insufficiently collateralised or not collateralised at all. This supposition is derived from the numbers on non-collateralised transactions set out in the ISDA Margin Survey of 2009. This survey indeed appears to indicate that one third of the overall derivatives exposure is uncollateralised. However, the relevant survey is misleading and does actually not support such a general conclusion:

For one, the survey focuses on daily margining based upon the ISDA Credit Support Annexes (CSA) and consequently does not take into account alternative forms of collateral such as guarantees, pledges, charges or liens provided by the counterparty or third parties outside or independently from a CSA. Also, in respect of certain types of counterparties, such as sovereigns or public entities, posting of collateral may actually not be required or possible.

In fact, as will be further outlined below, adequate collateralisation is a core interest of all institutions, so that there is a natural incentive to ensure sufficient collateralisation of transactions. In any event, the existing regulatory requirements under the Banking Directive already incentivise adequate collateralisation.

(6) Are there markets where daily valuation, exchange of collateral and portfolio reconciliation cannot be the goal? Please justify.

In general, institutions have a strong interest in frequent, and ideally, daily valuation and margining.

Having said that, there are significant practical impediments which make it unlikely that it will be possible to introduce daily valuation and margining for all market participants and products. For one, this would require considerable investments in infrastructure and personnel, in particular on the client side. At least where the transaction volume is comparatively low or in respect of small and medium sized entities, these investments would pose a disproportionate burden in relation to the comparatively limited positive effects on risk exposure to be expected from the introduction of a higher frequency.

In any event, it would be necessary from a practical point of view, and, if accompanied by the appropriate risk mitigating measures, also acceptable from a credit risk point of view, to allow exceptions, for example a longer period between valuations or the introduction of minimum thresholds for certain types of counterparties.

(7) How frequently should multilateral netting be used?

Trade compression achieved by way of novation netting also directly serves the interests of institutions by reducing their exposure. Consequently, the banking industry is using available trade compression services such as TriOptima to a considerable extent.

As to the frequency, compressions should ideally occur as often as practicable. Having said that, it will not be possible to set out predetermined fixed schedules since trade compressions can only be effected when a sufficiently high amount of appropriate transactions has accumulated. For example, with regard to CDS transactions, trade compressions occur up to 12 times each week. However, it is not possible to set a firm minimum or maximum number of weekly compressions.

In any event it will need to be taken into account that not all transactions of an institution may qualify for such a compression or all compression cycles in accordance with the relevant internal risk mitigation strategy. Thus, institutions do require flexibility in respect of the transactions which are to be included in a compression.

(8) *Should bilateral collateral management be left to self-regulatory initiatives or does it need to be incentivised by appropriate legislative instruments?*

Effective bilateral collateral management is a core interest of all institutions. As it affects the credit risks, there are already sufficient and very strong incentives in place to implement effective and sound collateral management mechanisms. As far as institutions are concerned, the existing regulatory framework of the Banking Directive (Directive 2006/48/EG) already encourages institutions to use financial collateral arrangements by reducing the capital charges for risk exposure covered by such arrangements. In addition, further improvements are constantly being implemented by the industry, for example the initiatives to improve dispute resolution and reconciliation processes. We therefore cannot recognize any need for further regulatory incentives in this area. Also, it would be difficult to identify what type of further incentives would better serve the desired purpose than the already existing ones.

- **Central Data Repositories**

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

The banking industry supports the proposal to extend the use of a central data repository not only as a tool for increasing the efficiency of transaction processing but even more so as a measure to increase transparency for the regulatory authorities. Whether and to what extent the

expansion of the use of a central data repository to a broader range of derivative products is useful and practical, should therefore be explored. In respect of Equity and Interest Rate Derivatives, initiatives to establish central data repositories are already underway. In principle, central data repositories should be used for those products where the transaction volume is significant enough to merit the establishment of the required infrastructure.

Also, in the markets where commercial or industrial entities play a significant role, which is the case in certain commodity markets, a central data repository which only collects data from financial institutions would be of little practical use.

Having said that, inefficient structures and redundancies need to be avoided; not only in the interest of cost efficiency but also to ensure that the central data repository is able to fulfil its function as an instrument to improve transparency. Against this background, clearly, the establishment of multiple central data repositories for the same class of products should be avoided as this would have counterproductive effects. A multitude of competing data repositories may not only result in a fragmentation of the available information but also severely complicate the reporting structures which would necessarily affect the reliability of the information.

Ideally, therefore, there should be only one central data repository for each class of derivative products. However, if multiple data repositories with overlapping coverage of product classes cannot be avoided, at least full interoperability between these repositories would need to be ensured. In particular, a need for multiple reporting of transactions must be prevented. To further streamline the reporting process vis-à-vis the relevant regulatory authorities, it could be considered to establish a direct link to the data repository for the relevant authorities.

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

Other than regulations governing the access of the relevant competent regulatory authorities to the information required for regulatory purposes and the confidentiality of the data received from the counterparties, we do not see the need for extensive regulatory requirements.

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

Here, a clear distinction has to be made between information to be made available to the regulatory authorities for regulatory purposes and information to be provided to the market and the general public.

The competent regulatory authorities of course need to have access to the extent required to fulfil their respective regulatory duties. Generally, they should therefore have broad access to aggregate information as well as information on individual transactions.

A similar need for access to information does not exist in relation to the general public or market participants: For one, certain information on individual transactions cannot be disclosed as it includes trade secrets and other sensitive data. Leaving aside the aspect of data confidentiality, information on the individual transactions would also be of very limited practical value. In contrast to other markets, the commercial terms and the structure of individual derivative transactions, even standardised ones, differ greatly from each other. The main reason is that terms and structure depend on such a multitude of factors that in many cases even derivatives of the same class cannot be compared. In fact, the terms applicable to a subsequent derivative transaction concerning the identical underlying executed only shortly after the first one may already differ significantly from the previous one. Disclosure of information on the individual transactions would thus not help the market participants to compare, for example, pricing, and would actually be misleading. Even information on an aggregate level may be of only limited practical value. The aggregation of such data could actually compound the problem as the resulting aggregate data may even be less useful as reference point for market participants.

Publicly available information should therefore be limited to basic aggregate information. The type of aggregate information to be provided would necessarily depend to a great extent on the class of derivatives involved. It might also be more appropriate if such aggregated information were to be published not by the data repository itself but instead by the regulatory authorities. These would be able to place the information in the correct context and could also add additional observations and conclusions from a regulatory perspective which might be helpful to prevent misconceptions or misunderstandings.

In this context, it should also be considered that too extensive or complex disclosure obligations may ultimately work as a disincentive for making full use of the data repository.

A second question directly related hereto concerns the type and amount of information to be provided by the counterparties to the data repository. In order to ensure efficient and reliable

reporting by the counterparties and processing of the incoming information by the data repository, the information to be provided needs to be limited to the strictly necessary such as information on the asset class, product type, effective notional amount and currency as well as the function of the party submitting the information in the transaction (buyer or seller).

- **Move Clearing of Standardised OTC Derivatives to CCPs**
- **Defining CCP eligible contracts**

(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?*

The decision on which type of derivative products should be eligible for CCP clearing cannot be left to the CCPs alone: Of course, a CCP cannot and should not be forced to accept products it does not consider eligible and is not prepared to clear. Thus, the right of CCPs to reject clearing of certain products should not be restricted in any way. However, the fact that a CCP considers a product eligible for CCP clearing may not be a sufficient safeguard that clearing is in fact practically feasible or useful. There may be a number of valid reasons why the counterparties may arrive at the conclusion that the use of a particular CCP or clearing of a certain product is not appropriate. For example, the counterparties may believe that the changes to the product structure required to allow clearing render it useless for the purposes it was conceived for (of course, here it could already be doubted whether it can be said that the two are actually the same product). They may also have reasons to believe that the applicable clearing rules and regulations of the relevant CCP are inappropriate. Moreover, it needs to be considered that all parties using the services of a CCP will to some extent have to absorb the risks the CCP accumulates: The collateral they post will not only be used as security for the transactions of the posting party but also, to some extent, to secure the risk of defaults by other parties. All users will thus always have a vested interest in the type and scope of activities the CCP engages in, including the type of products it intends to clear as well as the trade volume it intends to accept, as this directly affects the risk profile of the CCP.⁴ Therefore, eligibility should be determined with the joint consent of both the users and the relevant CCP. Such joint consent would actually be indispensable in the event that any form of presumption were to be introduced that a product which at least one CCP is prepared to clear is automatically

⁴ For the same reasons, there cannot be a presumption of eligibility for CCP clearing only because one CCP is prepared to offer clearing of said product.

considered as eligible for CCP clearing in general, and if such presumption were to be combined with a direct or indirect obligation to commence CCP clearing of such product.

As to the method how such joint decision making is to be accomplished, various approaches may be considered. One solution (which also appears the one the second part of the questions is alluding to) could be through the governance of the CCP. This could indeed be designed in such a manner that it ensures that the consent of at least a qualified portion of the user community is required for the expansion of the activities of the CCP affecting the risk profile (be it in terms of volume and in terms of products accepted for clearing or with regard to other material issues). A mere consultation obligation would not be sufficient.

Another important issue which at least indirectly affects the level of acceptance of a certain CCP by the potential users and thus also the products it is prepared to clear, is the efficiency and soundness of its default management structure. Sufficient participation by the users in any material decision affecting this structure (including margining levels and evaluation of the results of any stress tests) would thus also be necessary to ensure broadest possible acceptance of the CCP. Past experience with existing CCPs shows that the arrangements in place allowing user participation (such as risk committees) are currently not entirely satisfactory.

- **Incentives to use CCP clearing**

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

Although desirable, it is unlikely that interoperability of CCPs can be achieved in the short term and thus can currently only be a long term objective. Against this backdrop, we feel that in the meantime, consistency of approaches to clear transactions and to manage product lifecycles would bring additional benefits to clearing members and their clients.

Depending on design and arrangements of the CCP and on whether data repositories exist or not, they may facilitate reporting to authorities via the information they acquire.

The possibility to cross-margin over a range of products cleared by CCPs could help prevent unnecessary costs for clearing clients. Furthermore, portfolio compression offered by CCPs could help minimising costs and risks for all participants.

What should be kept in mind is that – at least for an extended transitional period – there are also potential disincentives for using CCPs. The advantage of multilateral netting offered by a CCP could well be outweighed by the disadvantages resulting from the loss of the ability to net with counterparties bilaterally. The scale of this possible drawback is the largest in the event of a migration from a bilateral clearing environment covering a broad range of products to a multilateral netting environment fragmented over different asset classes (i.e. distinct CCPs).

As to the importance of account segregation in order to facilitate indirect access to a CCP, in particular for small and medium sized institutions, see our response to question 15 below.

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

We believe the zero-risk weighting to be a sufficiently powerful way of incentivising CCP clearing of adequate derivatives, especially during times when regulatory capital is a scarce resource and becoming more expensive with the new capital requirements applied to the trading book. Banks will use their capital in the most efficient way and therefore the risk weighting advantage of CCP-cleared derivatives compared to bilaterally cleared transactions will drive market participants to make use of CCPs whenever possible. Notwithstanding that bespoke derivatives may not be suitable for CCP clearing for other reasons.

To uphold this competitive advantage of CCP clearing there should be clear rules as to what constitutes a CCP and these conditions should not distort competition in any way. We feel that the ESCB/CESR recommendations lay down a solid foundation for safety and soundness of CCPs. But at the same time we are concerned that presupposing acknowledgement under the Settlement Finality Directive might be cumbersome.

(15) Should additional requirements, such as appropriate account segregation, be introduced to apply the zero-risk weighting to indirect participants?

We support measures that enable indirect participants to benefit from the zero risk weighting of a CCP. Appropriate account segregation is a means of achieving this. Whether it is the only way depends on the legal structure. Liens on collateral or a guarantee by the CCP to return collateral to the indirect participant are alternatives.

(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?

To start with we would like to clarify that speaking of penalties should not be taken to indicate that those institutions that are being penalised are acting improperly or in breach of existing rules and regulations. As set out above, there may be many valid reasons why an institution cannot rely on CCP clearing and thus has to continue with bilateral clearing. For instance it could very well be that small institutions are not capable of establishing links to a CCP because of the small volume they generate. We are convinced that the rules of the Banking Directive are sufficient in this respect, and that clearing should blend in with established banking regulations.

We believe that punitive capital charges for CCP-eligible derivatives not centrally cleared do not help the aim of enhancing market stability. The reasons for not using a CCP for CCP-eligible derivatives can be manifold. There are, for example, growing concerns amongst German treasurers in the non-financial sector who believe that CCP clearing would impair their ability to hedge their risk position effectively and at existing costs levels. Against this background, some treasurers have already announced that they will not use a CCP and that they are not prepared to be forced into CCP clearing. This raises the question how non-banking market participants on the buy-side may be encouraged to use CCPs.

Impediments may also exist on the institutions' side. Offering clearing services requires expensive infrastructure and will therefore be limited to those banks that are willing and able to make the necessary investments and that actually have the "critical mass" of transactions to handle clearing in an efficient manner. Small and medium sized institutions might not be able to make these investments in the required infrastructure. Some of them may be able to do so, but will be inclined to obtain a single membership only, with a clear preference for the CCP in their local market. Thus, they would be reluctant to become a member of a CCP in another jurisdiction even if the relevant CCP offers clearing capabilities which the domestic CCP does not.

If "CCP-eligible" is intended to mean that at least one clearing house is offering to clear the same product then punitive charges might, moreover, distort competition. They increase the cost of trading OTC derivatives for those credit institutions that are not able to offer CCP clearing or to force their customer into the system. In particular the competitiveness of smaller

and medium sized institutions which do not have a direct access to a CCP capable of clearing the relevant products would be affected by such punitive charges. Ultimately, punitive charges would therefore lead to a higher concentration of OTC business in fewer institutions.

A zero risk weighting is a sufficient incentive, and the evolution of CCPs for other derivatives supports this view.

(17) Under which conditions should exemptions [from penalties for clearing standardised products outside the CCP] be granted and by whom?

We do not believe that bilateral clearing should be penalised as sufficient incentives for CCP clearing are already in place. If however, such penalties are to materialise exemptions should be granted at least in all cases where clients demand contracts that are bilaterally cleared. Taking away the possibility from clients to hedge their risk in a cost efficient way could stifle innovation and economic growth.

If punitive charges apply, regulators should be the ones granting exemptions. Exemptions should apply if, for example, a market participant creates and maintains an effective hedge under generally accepted accounting principles or if a bank does so at the request of a client.

(18) What is the minimum acceptable ratio of CCP cleared/eligible contract? What is the maximum acceptable number of non-eligible contracts?

We wish to refrain from quoting any numbers, as we do not think this is possible, given all the dependencies. First of all, it will depend on the specific derivative product and the characteristics of its market.

Secondly, to a certain degree it depends on who is to decide on CCP-eligibility. For example, if an overall ratio of cleared or eligible is fixed the entity in charge of declaring eligibility can drive the market towards a – possibly inefficient – higher degree of CCP clearing by simply declaring products as eligible that start with a lower ratio. This is not to say that we oppose a high degree of CCP clearing but simply that setting a fixed ratio gives a great deal of power to those deciding on the eligible product list.

Thirdly, as already mentioned earlier, the derivatives market is driven to quite some extent by clients' demands. Therefore it is hard for institutions, in particular universal banks as opposed to investment banks, to steer the cleared or eligible ratio without neglecting clients' needs.

The above said is also the reason why we do not see any benefit in seeking to put an upper bound on the maximum number of non-eligible contracts. Non-eligible contracts should be subject to operational best practices, with high levels of electronic trade processing, lifecycle management and transparency applied to them. This is also the goal even if they are not centrally cleared and remain collateralised bilaterally. For bespoke contracts that are not eligible for standardisation necessary for CCP clearing, being cleared bilaterally does not automatically mean a higher systemic risk.

If however, benchmark ratios are sought after by compiling actual numbers, the business model of institutions drawn on should be taken into account. The average ratio should not limit the ability of specialised banks to fulfil clients' needs.

(19) What statistics need to be provided to regulators to make sure they have all the information necessary to perform their duties?

We feel that regulators are best suited to answer this question.

- **Ensuring safety and soundness of CCPs**

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

We very much welcome the ESCB/CESR recommendations stating that each aspect of a CCP's risk management and operations should be legally well-founded, sound and safe. We believe that these recommendations are a big step forward towards achieving the aims mentioned in the consultation paper and shared by all market participants (such as proper structure, appropriate organisation, effective supervision, fair access, business continuity arrangements and effective risk management). Regulators need clear lines of jurisdiction and market participants need certainty that their business transactions will not be held to conflicting standards of conduct. Legal certainty also has an international dimension, considering the

global nature of OTC markets. A set of harmonised minimum standards are therefore important to establish a competitive environment.

Therefore, by following through with the ESCB/CESR recommendations, by making sure that these are consistently implemented and applied and by establishing international cooperation among regulators we believe that all challenges mentioned could be dealt with adequately.

Only if developments over time clearly demonstrate that ESCB/CESR recommendations and accordingly CPSS/IOSCO standards are not sufficient in themselves to achieve these aims should the European Commission consider putting in place consistent and convergent regulatory regimes across jurisdictions. In this case, too, regulators should cooperate across boundaries to ensure and supervise consistent adherence and hence a level playing field.

To a degree cooperation between regulators is starting to happen, with the reengagement of CPSS/IOSCO with standards for CCPs. We welcome this initiative as a further sign of successful international cooperation. When updating the CCP recommendations to encompass clearing of OTC derivatives we urge CPSS/IOSCO to make use of ESCB/CESR spadework - including its key approach of limiting the scope to infrastructures - and to prevent any unjust misalignment of ESCB/CESR and CPSS/IOSCO. We furthermore believe that competition based on a level playing field is beneficial for the market. At the same time, competition must not diminish systemic stability in any way.

- **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?

No. First of all, we would like to point out that the primary goal of this consultation is mitigation of systemic risks. Pursuing inter alia investor protection and detection of market abuse (see question 22) – while important goals if looked at separately – should not be commingled with banking supervision. Our deliberations here and under question 22 are therefore limited in this respect.

The starting point for the considerations regarding transparency obligations are the provisions in Articles 28 and 45 of the MiFID (Directive 2004/39/EC). These articles stipulate that all interested investors are to be notified immediately of all transactions in shares – whether

concluded on a stock exchange, an MTF or bilaterally between two contractual parties. Article 65 Par. 1 MiFID, moreover, contains an opening clause for an extension of the transparency obligations to securities other than shares. Against the background of Article 65 the European Commission published a report in April 2008, in which it concluded that *„there does not seem to be, at this point in time, a need for regulatory intervention at community level in terms of expansion of the current transparency provisions of MiFID to financial instruments other than shares. Existing national arrangements appear to work satisfactory”*. This was preceded by consultations of the market participants by CESR.

While we acknowledge that the recent crisis does call for an overhaul of rules and regulations, we have consistently expressed the view that the lack of a formal transparency framework for non-equities products does not necessarily hamper market functioning. We feel that strengthening of bilateral and central clearing goes a long way towards achieving more resilient markets. Market transparency can only help if the information provided does deliver benefit to the recipient. In practice, investors in derivative products find dealer quotes of much more relevance than past price and volume data. Additionally, traded derivatives are manifold. Even small differences in the design of the products can have major economic implications for the respective product. If, therefore, under a stricter transparency regime only market data of similar but not identical products are available, there is a danger of the interested market participant making their decisions on a false basis. On the other hand, setting-up a post-trade transparency system would involve high costs and a high level of work; as a result a negative cost-benefit balance could be difficult to avoid.

We agree in principal that an asymmetric information position on the markets for some derivatives has damaged the functional capability of these markets. However, it must be noted here that it concerns an asymmetry of the information about properties and modes of action of the finance products and not a deficiency of information with regard to the prices traded on the market. An extension of price transparency could neither have prevented the crisis, nor mitigate it as only symptoms would have been fought without looking at the cause.

In the past we have also mentioned on various occasions that markets will evolve towards more efficiency if this is considered optimal. We would like to refer for example to www.isdacdsmarketplace.com in this respect, a comprehensive source of information for investors.

However, should the European Commission push for a transparency regime for non-equity products, we would find the introduction of such a framework acceptable subject to the following conditions:

- Restriction to post-trade transparency – as opposed to pre-trade transparency requirements, which could severely damage the functioning of the market
- Post-trade transparency requirements should be limited to tradable instruments. The industry would look forward to being involved in the definition of tradability.
- The impact of such a regime on liquidity and spreads would have to be assessed periodically and should commence shortly after its introduction.

As we mentioned earlier, we are supportive of central data repositories. To prevent redundant workload and costs as well as the production of an overflow of unused data, it should be analyzed how a central data repository could help to strengthen market transparency as well as how the data is to be analysed and by whom. But, at the same time, our view that certain information is only for regulators and not for the wider public still holds.

- ***Transaction reporting of OTC derivatives***

(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?

We consider it important to clarify some references made in the Commission's consultation and staff working papers to the ongoing work of CESR in the area of transaction reporting of OTC derivatives:

- Section 6.2 of the consultation paper gives the misleading impression that CESR is already examining the need to extend the scope of Article 25(3) of MiFID. The working paper refers in this connection to CESR's Call for Evidence on the Technical Standards to Identify and Classify OTC Derivative Instruments for TREM of 2 February 2009 (CESR/09-074). However, CESR's call for evidence deals exclusively with technical aspects of the exchange of transaction reports on certain OTC derivatives.

- In its consultation paper published on 22 July 2009 on “Classification and identification of OTC derivative instruments for the purpose of the exchange of transaction reports amongst CESR members” (CESR/09-618), CESR states that its proposals on exchanging data refers at this stage only to transactions in OTC derivatives whose underlying instrument is traded on a regulated market. In addition, the derivatives must be single-name instruments except when different underlying instruments all refer to the same issuer. These restrictions in scope reflect the reporting requirements being advanced in some EU Member States that are extending their national reporting requirements to cover some types of OTC derivatives. The Commission staff’s working paper, however, does not similarly confine itself to addressing a specific category of OTC derivatives.

Against this background, we note that:

- a) CESR is not examining the need to extend the scope of Article 25(3) of MiFID to OTC derivatives transactions. The reports required under Article 25(3) of MiFID are primarily intended to enable competent authorities to detect market abuse, particularly the misuse of inside information (and not to help authorities respond to the financial crisis).
- b) The issue at stake is how to improve transparency with the aim of identifying and combating systemic risks at an early stage. First and foremost, therefore, the fundamental question arises as to whether and how OTC derivative transaction reporting would really help to achieve this objective. This question needs to be considered very carefully, as discussed below.
- c) The Commission needs to take stock of experiences with transaction reporting in instruments admitted to trading on a regulated market. Some of the main features of this type of reporting are: (i) reports contain sheer number of transactions; (ii) reports are generated automatically; (iii) reporting firms have set up extensive systems for this purpose and their efficiency has been tried and tested over the years; and (iv) supervisory authorities have developed automated, effective data evaluation processes

As a consequence of the above, even if there are likely to be fewer data sets about OTC derivative transactions, automated evaluation would be essential if sense were to be made of the data. The data sets would also have to be generated automatically. It would, for instance, be necessary to design the reporting fields in such a way as to enable data to be entered and evaluated automatically. The classification system outlined in section G of consultation

CESR/09-618 for the OTC derivatives considered by CESR could offer a suitable basis. If transactions in other OTC derivative instruments were also covered, similar systems would need to be developed. In addition, decisions on precise specifications and conventions on meta-language protocols would be required.

In addition to methodological aspects, we are concerned by the scope of a possible transaction reporting system and, against this background, it is no coincidence that the EU Members States that have made some advances in this area have limited their reporting requirements to certain categories of OTC derivatives.

We believe that transaction reporting is not a suitable means to identify and combat systemic risks. We propose to analyse the scope of data repositories in more depth to achieve this aim.

(23) How should position reporting of 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 the exposures to particular contracts?

The aim of this consultation and resulting initiatives is to strengthen the resilience of the OTC markets, i.e. mitigating systemic risks. We feel that position reporting clearly takes preference over an extended transaction reporting regime (see reply to question 22). Position reporting is well suited to make competent authorities aware of firms' exposures and to improve market oversight. Since market stability is the goal that the measure should focus on, we would like to point out that the question of whether position reporting might also help detect abusive behaviour is of little relevance. We concur with the view of the European Commission that consideration will need to be given to the level of granularity and costs for firms associated with reporting. We believe that finding practicable tools for reporting from banks to supervisory authorities is crucial. Adequate reporting tools will have to be identified taking stock of supervisors' and banks' technical systems alike. Moreover, the need for systems to be able to analyse information received not only from market participants, but also from other authorities, will have to be taken into account. Only in this regard could TREM be a blueprint.

Part of this analysis should be what information the regulators already have, e.g. from reports under pillar 2. Furthermore, to prevent redundant workload and costs, it should be analysed how a central data repository could help position reporting. But at the same time our view that certain information is only for regulators and not for the wider public still holds.

- **Move to public trading venues**

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

OTC and derivative trading on regulated markets (i.e. derivatives exchanges or multilateral trading facilities) each have a separate, distinctive and logical reason to exist. In particular, in the derivatives space, the relationship between OTC and non-OTC markets is more often complementary than competing. Standard exchange-traded contracts very rarely provide a perfect hedge for actual economic risk. By contrast, users of OTC markets can use non standardised financial products to hedge their risk more precisely.

We acknowledge that some types of OTC asset classes may over time become commoditised and migrate to the exchange environment or multilateral trading facilities, but we disagree with the Commission in envisaging this move as “the next logical step”.
