

House of Lords European Union Committee
Sub Committee A (Economic and Financial Affairs and International Trade)
Commission communications on ensuring safe and sound derivatives markets
Memorandum from the Financial Services Authority (FSA) and HM Treasury

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

Response to specific questions asked by the Committee

Derivatives

- **What economic benefits do derivatives bring?**
 - **What risks are associated with derivatives and derivatives markets?**
 - **What role did derivatives play in the recent financial crisis?**
6. Derivatives have historically been used for hedging purposes, for example to protect both financial and non-financial firms against unforeseen currency fluctuations. Such hedging activity allows firms to disperse risks, which they are ill-equipped to manage, to other firms who can appropriately manage the inherent risks. This can reduce the cost of raising capital for firms where they have hedged their non-core business risks. The ability to manage risk more effectively can support growth and innovation in the core business, which in turn can lead to economic growth.
 7. The market has developed considerably, and OTC derivatives are now widely used by a variety of participants for a range of purposes. The recent financial crisis has highlighted weaknesses in the current regulation of this market. As these weaknesses have materialised, the overall stability of financial markets has been threatened. These weaknesses include an acute sensitivity and exposure to the risk of the default of a counterparty, and an overall lack of transparency within the

market – both to regulators in terms of information on underlying positions but also to market participants.

Clearing Directive

- **Should CCPs be supervised at a national or EU level? What benefits will a Directive at EU level bring?**
 - **What provisions and rules should regulation impose to improve the operation of CCPs and reduce risks associated with derivatives markets?**
 - **Should central clearing be made mandatory for standard derivatives through amendments to the Markets in Financial Instruments Directive (MiFID)?**
8. We believe that there is a need for a harmonised regulatory framework for CCPs¹. In addition to providing a set of harmonised standards for the regulation of CCPs which would need to be consistently applied across Europe, an EU Directive would provide for better cross-border access. This in turn will lead to positive competitive pressures.
9. As a consequence of the proposed reforms CCPs are likely to grow in systemic importance. It will therefore be essential that the risk of a failure of a CCP is adequately mitigated. Capital, in the form of member margin-funds, a member-financed default fund and the CCP's own capital, will provide the first line of defence. However, there will remain the risk that public authorities would need to step in to provide support. As the Commission or a pan-European regulatory authority would be unable to bear the fiscal burden in the event of a failure of a CCP, we believe that primary supervisory responsibility should reside with the home state.
10. Although much of the current debate is focused on CCP clearing for standardised derivatives, we believe the availability of pricing, the degree of market liquidity and the ability of the CCP to effectively risk manage the exposure should also be considered in deciding whether or not a product is suitable for CCP clearing. Whilst we strongly support the greater use of CCP clearing for clearing eligible derivatives, we do not support proposals to mandate CCP clearing for all standardised derivatives. We believe this approach could be counter-productive and ultimately lead to greater risk in the system². We prefer an approach where regulators set extremely high and challenging targets for CCP usage (current targets are moving towards a requirement that 95% of clearing eligible business is cleared), actively monitor progress against these and take action when they are not being met.

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

11. In our view, the capital treatment of all OTC derivatives, whether centrally cleared and standardised or not, should be proportionate to reflect the risk posed to the financial system³. The Basel Risk Management and Monitoring Group is currently

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

² *Ibid*: Paragraphs 4.5 - 4.9

³ *Ibid*: Paragraphs 6.6 - 6.14

considering this issue and we expect the outcome to be that the capital treatment for non-centrally cleared trades will rise above current levels.

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

Trade Repository Directive

- **What benefits the use of trade repositories bring both in terms of transparency and improved risk management?**
 - **Should the EU regulate the legal framework for the operation of trade repositories?**
 - **What provisions and rules should such regulation impose to improve regulation of trade repositories?**
 - **Should trade repositories be supervised by ESMA or by national supervisory authorities?**
13. We strongly support increasing the transparency of OTC derivative markets by having more information on the underlying positions of market participants and supporting a more efficient price formation process. A trade repository can play an important role in this process. It is a piece of infrastructure which centrally collects and aggregates data on OTC derivative transactions and then disseminates the data to relevant parties. The introduction of trade repositories will be fundamental in improving transparency to regulators as they will help identify potential sources of concentration risk and market instability and will support financial stability planning. The publication of aggregate information to the market will assist with the price formation process. Industry is already making good progress in establishing trade repositories for a number of asset classes. We support this work.
 14. Work is already under way at international level through the OTC Derivative Regulators forum to design appropriate reporting templates and to put in place appropriate information-sharing arrangements.

Further issues

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

15. We welcome the Commission's intention to review the Market Abuse Directive (MAD). We would welcome an amendment to include Credit Default Swaps (CDS) as a financial instrument that falls within the scope of the Directive because traders who have access to information about the financial position of the issuer of a reference asset may find it more profitable to trade in the CDS market.

⁴ Ibid: Chapter 5 'Strengthening risk management for non-cleared trades'

As trading in CDS may be more liquid and less transparent, it could provide greater scope for concealing abusive activities.

16. We would not support the MAD regime being extended to encompass physical commodity markets. However, we recognise that there may be merit in exploring the potential for creating a separate anti-abuse regime covering physical markets, outside the scope of financial services regulation.
17. We are in favour of all policy measures that are designed to prevent manipulative behaviour in derivatives⁵. However, we have not seen evidence that a blanket approach through specific position limits is the most effective way to monitor, detect and deter manipulative behaviours in derivative markets, whether they are on-exchange or OTC. In our view a broader position management approach which does not focus on one type of participant is the most effective approach to ensuring integrity in derivative markets.

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

18. As noted above, a certain proportion of the market will never be suitable for central clearing. It is essential that these transactions are subject to robust and transparent risk management procedures so that the failure of a major counterparty does not cause a market failure.
19. We support risk-proportionate capital charges for bilateral counterparty exposures in order to motivate firms to adopt the identified best practices associated with bilateral collateralisation arrangements⁶. There may be some non-systemic, non-financial users of derivatives which would not be able to post collateral. This is because they do not have access to the type of credit facilities that would be necessary to raise the funds required. Although we are encouraging industry to make improvements to its approach to bilateral collateralisation, we recognise there may not be a “one-size fits all” solution. We are therefore considering whether we should pursue an alternative counterparty risk management approach for these types of derivatives users⁷.

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

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

⁵ Ibid: Chapter 9 ‘Position limits’

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

⁷ Ibid: Paragraph 4.22

the mandatory use of exchanges being promulgated more strongly in the US than in Europe⁸.

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