EACB position paper on consultation of the European Commission on Derivatives Markets and Infrastructures

09 July 2010

The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.200 locally operating banks and 63.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 160 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 50 million members and 750.000 employees and have a total average market share of about 20%.

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General Remarks

The European Association of Co-operative Banks (EACB) would like to thank the European Commission for the opportunity to respond to its consultation on Derivatives and Market Infrastructures

EACB supported from the beginning the calls for more transparency and stability in the derivatives markets as outlined in the report of the "de Larosière"-group (February 2009) and in the conclusions of the G20 summits in London (April 2009) and in Pittsburgh (September 2009).

We nevertheless have to express some reservation as regards the approach proposed in the consultation paper in that it is specifically designed for major counterparties with big OTC derivatives positions. However, there are many smaller financial and non financial counterparties, who use derivatives only for hedging purpose and this should also be taken into consideration in order to make the legislative approach appropriate and balanced. We would like to emphasise that we would be against a one size fits all approach as many small banks as well as small to medium sized corporate end users currently execute all their OTC derivatives transactions according to national law and by using their own language. The proposed model would force these parties to enter into agreements under foreign legislation and in foreign language, undermining the legal certainty for these parties.

In the following outlines EACB would like to point out responses to selected questions raised by the Commission in its consultation document:

I. CLEARING AND RISK MITIGATION OF OTC DERIVATIVES

1. Clearing obligation, 2. Eligibility for the clearing obligation, 3. Access to a CCP

Questions:

What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivate contracts for mandatory clearing, and its application?

Eligibility

OTC derivatives are generally customized products that aim to meet specific requirements of the parties involved. Different counterparties may be interested in having the transaction being governed by different types of master agreements. Further aspects may be the underlying, settlement instructions, termination rules or the size of the transaction.

It is very probable that a CCP will not be able to consider all of the mentioned characteristics of a transaction. It is currently unclear how OTC derivatives will be treated in case a CCP should be unable to meet the requirements of the parties involved in a specific transaction. In such a case the parties would be obliged to use another CCP which offers clearing services for the specific transaction and would therefore incur unreasonable additional costs (e.g. becoming client of another clearing member, posting collateral, etc.) which are not in a reasonable proportion to the benefits of CCP clearing in general.

We have additional comments with respect to the process for determining clearing eligibility as described in the consultation paper:

- An implementation period of six months is not feasible because of the very time-consuming technical as well as process related implementation.
- We call for more specific explanations with respect to the "objective criteria" ESMA will base upon its decisions on whether a certain class of derivatives should be eligible for the clearing obligations, especially the criteria on systemic risk reduction.
- We appreciate that there will be a market consultation before ESMA will which classes of derivatives should be eligible for the clearing obligations.
- We fully understand that a right of initiative has to remain with ESMA (2.d). We nevertheless call for a public consultation whenever ESMA identifies additional derivative contracts to be added in the public register. There are not enough details in the consultation paper on the procedure ESMA will follow when identifying new contracts as clearing eligible.
- We would like to highlight that grandfathering provisions are missing.
- We would like to stress that the risk committee should play a role in the context of declaring a class of derivatives as clearing eligible.

Access to a CCP

Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

Yes, we agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed.

4. Non-financial undertakings

Question:

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

Threshold

We would like to underline that hedging transactions always limit existing risks independently of their volume. We therefore consider thresholds for hedging transaction as useless.

It remains unclear how a party should identify if its counterparty has already exceeded the clearing threshold. An additional open matter is the question on how derivatives are treated if the threshold has been exceeded by one of the parties not at the beginning of the transaction but in the course of the transaction. In both instances the other party could be surprised by equity capital requirements not being considered at its initial pricing. This should be avoided.

Reporting requirements

We would like to emphasise that too many information and reporting obligations may hamper non-financial counterparties to enter sound risk management contracts. This would be completely against the objective of the upcoming EU provisions.

Differentiation between financial counterparties and non-financial counterparties

The distinction made by the European Commission on whether hedging transactions are entered into by a non-financial or a financial counterparty is questionable. Also financial counterparties should have the possibility of obtaining an exemption for derivative positions which on substantiated grounds were entered into in the context of actual risk mitigation. Hedges should not be subject to the clearing obligation – neither for non-financial counterparties nor for financial counterparties.

Since hedges need to precisely reflect the hedged position, in many cases they might not be "eligible" – for example where the interest payment date or the maturity differs from the derivative contracts that qualify as eligible. These deviations from the standard should not be qualified as a wilful evasion of the clearing obligation by the financial counterparties.

Question:

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

5 b) - Processes

The provisions for non-financial counterparties might prove counterproductive as they may prevent them from entering into any hedging instruments because of the burdensome process requirements. Non-financial counterparties could either neglect their risk management or they could be forced to enter into a contract with a non-financial counterparty for risk mitigation purposes. In the latter case, the consequence could be that the default risk of the non-financial counterparty will be even higher than the contract with the financial counterparty.

II. REQUIREMENTS FOR CENTRAL COUNTERPARTIES

1. Organisational Requirements, 2. Risk Committee, 3. Conflicts of Interest, 4. Outsourcing, 5. Participation requirements, 6. Transparency

Questions:

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?

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

Risk Committee: Only in exceptional circumstances should it be permissible for a CCP to overrule the demands or recommendations of the risk committee. We agree that such an exceptional case should be brought to the attention of the competent regulatory authority (allowing intervention where necessary).

Outsourcing: It should be clearly defined, which function may not be outsourced (e.g. management duties); bullets 2 and 3 are not very precise (What is an "effective change"? At what point are obligations "altered"?).

Participation requirements: Generally, we welcome the main principle that all market participants shall have full access to a CCP. Nevertheless, it needs to be pointed-out that it is very likely that investment companies respectively investment funds but also smaller banks will not meet the requirements for a clearing membership at the CCP. For that reason, a CCP should provide an alternative for market participants who are not able to meet the requirements for a clearing membership.

Furthermore, where does the economic need come from to require "additional" financial resources and what is meant by "financial resources"?

7. Segregation and portability

Questions:

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

We generally welcome items d) and e). However, the legal and practical realisation is not clear. As regards item d) it should not only be assumed but rather has to be made sure by means of appropriate legislation that the client is not exposed to the default of the clearing member. How is the direct link between the client and the CCP legally supposed to work? Item e) requires, that insolvency legislation is harmonised on a European level.

8. Prudential Requirements

Questions:

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?

Margin Requirements

It is our understanding, that item 7. a) and b) (Segregation and portability) and item 8. C (Margin Requirement) belong together. Therefore, it should be made clear that the assets and the positions of the clearing member (respectively of its client) and the margins belong together and should be segregated in the same way and be build altogether one segregated exposure.

In addition we would like to highlight the difficulty to call and collect intraday margins (item 8.C). It is unclear who should assess the market price.

Furthermore, does the limitation of the exposures of a clearing member towards the CCP automatically limit the obligation to provide additional funds in the event of a default of another clearing member (item 8. E. d)? Otherwise the obligation to provide additional funds would theoretically be unlimited (until all other clearing members are defaulted).

Finally, according to item 8. I. b) the CCP taking prompt action should at the same time "[…] ensure that the closing-out of any clearing member's positions does not disrupt its operations […]". This seems contradictory and does not show the consequences if this could not be achieved.

Default fund

Regardless of the question, whether a default fund is necessary at all, a default fund should only be established by contributions of the CCP itself. The CCP gains earnings from the clearing membership- and transaction fees. Before any parts of those incomes are being distributed to the shareholders of the CCP, they should be used for establishing the default fund.

Default Waterfall

Currently, every market participant knows its counterparty and is able to react on developments being relevant for the counterparty risk. If a clearing member should be liable for the default of another clearing member this means an unknown risk which cannot be reduced by the non-defaulting clearing members.

Therefore, only the CCP should be liable for its mistakes in the collateral management. Exchanges all over the world have implemented a working collateral management. We do not see why CCPs should not be reliable in this regard.

Investment Policy

With regard to collateral requirements and the investment policy of a CCP reference is made to "highly liquid instruments". ESMA should define which securities are considered as "highly liquid". Covered bonds should be part of such definition.

Furthermore, it should be avoided that clearing members are liable for the soundness of the CCP, especially for any mistake of the CCP regarding the collateral management, while the CCP invests its assets into various financial instruments.

9. Relations with third countries

Questions:

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.

III. INTEROPERABILITY

Question:

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

Interoperability enables clearing members to be a clearing member with only one CCP but to be nevertheless in the position to clear a wide range of derivatives. Nevertheless, we doubt that this concept can be effectively introduced in the area of OTC derivatives. For example, it is unclear, how the collateralisation works if a certain derivative is cleared by a CCP which is interoperable with the clearing member's CCP. Who will get the collateral? Normally, the collateral would have to be passed on to the CCP which actually clears the derivative. However, what happens in case the two CCPs having different ways of calculating the collateral requirements? Would there be additional claims or repayments?

IV. REPORTING OBLIGATION AND REQUIREMENTS FOR TRADE REPOSITORIES

1. Reporting obligation, 2. Requirement for Registration of a Trade Repository

Questions:

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

We fully support the introduction of an obligation to report derivative transactions to TRs as we believe that TRs are the single most important instrument to ensure transparency. To ensure that the future TR infrastructure can fulfil this purpose, it will be necessary to avoid any unnecessary fragmentation of the information. To this end, an internationally coherent reporting regime without unclear, duplicate or conflicting reporting obligations will be indispensible. Otherwise, it would be easy to circumvent reporting obligations by using, e.g. Chinese affiliates when entering into the derivatives contracts.

<u>Reporting obligation:</u>

Against this background, we would like to make the following comments in respect of the tow options presented.

- Option A: The obvious advantage of Option A is that the information collected in the trade repositories would be more comprehensive. It would also avoid the need for the implementation of processes for making the necessary (and in some cases complex) distinction between EU derivative contracts and other derivative contracts. As to the need for an internationally coherent reporting regime, see above and comments below regarding the options for registration of TRs)

- Option B: This option has the advantage that it would be possible to concentrate on segments of the markets which are more likely to be of interest to regulatory authorities in the EU. However, this option would raise extremely complex questions regarding the delineation between EU derivative contracts and others

(see above) and how to ensure that counterparties residing outside the EU can comply with such an obligation (in view of potentially conflicting local reporting obligations and/or privacy or data protection rules).

In addition, as regards the Party subject to the reporting obligation we would have the following general observations:

- The approach of Option B (each counterparty) has the following advantage: Reports from both sides of the transaction ensure that the data received by a TR is complete and represents the view of both sides of the transactions (in the case of a unilateral obligation, the financial counterparty will only be able to report its own perspective of the transactions). In addition, this avoids difficult legal questions over the right to transfer customer data (including information such as the identity of the other counterparty and other sensitive information) to a third party (the TRs), as each party would forward the data itself. Each counterparty would also become aware of the fact of such data transfer (see also our general comments on the need for a clear and comprehensive legal framework for the transfer of data to TRs and the access to such data in our general observations above).
- The approach described in Option A (unilateral by the financial counterparty), is, of course, simpler and relieves the non-financial counterparties from administrative burdens associated with the reporting obligation. These advantages and disadvantages will need to be weighed against each other.

Requirements for Trade Repositories

1. Operational reliability, 2. Safeguarding and recording, 3. Transparency and data availability

Questions:

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?

The governance arrangements of a Trade Repository shall ensure that it covers all master agreements (if it is necessary to have a master agreement in place with each of the clearing members).

The information stored in a Trade Repository shall be maintained at least as long as the parties to the relevant OTC derivative would be obliged to maintain the data.

For the avoidance of any possible insider knowledge advantages, the data stored at a Trade Repository especially is to be protected from the shareholders of the Trade Repository.

V. TECHNICAL REFERENCE GLOSSARY OF DEFINITIONS

Questions:

Do stakeholders agree with the definitions set out above?

- "class of derivatives" is not precise enough – what is "essential"?

Contact:

The EACB trusts that its comments will be taken into account. For further information or questions on this paper, please contact:

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