16 August 2010

Response to Consultation Paper on Standardisation and Exchange Trading of OTC Derivatives (the "Consultation")

Submitted to the Committee of European Securities Regulators ("CESR")

RBS Group ("RBS") welcomes the opportunity to respond to the Consultation and we have set out below what we see as some key issues arising from our analysis. We have also contributed to the joint ISDA/AFME/BBA/ASSOSIM/NSA response which we generally support, and where responses to each of the consultation questions have been provided. We trust you will find these comments of interest; we would, of course, be more than willing to expand further on any of these points if required.

RBS has been a long standing supporter of efforts to enhance the safety, efficiency and effectiveness of the OTC derivatives markets and has been at the forefront of a number of critical risk reducing initiatives. For clearing, we were one of the founding members of LCH SwapClear in 2000, which was a voluntary initiative organised by banks designed to improve counterparty risk management in the Interest Rate Swap market. It has been a tremendous success as evidenced by the volume of market activity it currently clears. As a G14 Bank, we have also been at the forefront of clearing initiatives globally and have devoted considerable resources to assisting in the development of CCP services for the dealer and end user communities for OTC Derivatives. We have also consistently met both clearing and operational targets.

We wish to emphasise that the issues being presented in this paper are multifaceted and interrelated with the potential for unintended consequences if approached hastily without ample consultation and industry engagement. It is important that policy makers are as clear, precise and consistent as possible when articulating their expected policy outcomes. We also recommend that CESR form working groups to pursue the key strands in greater detail and would welcome the opportunity to contribute to such an initiative.

Standardisation

We acknowledge the risk-reducing benefits of increased standardisation and support ongoing industry initiatives to enhance legal and process standardisation and, where driven by market needs and priorities, product standardisation. Through the G14 process, we and participant firms have shown our commitment to legal and process standardisation by fulfilling ambitious clearing, standardisation and operational efficiency targets, including those relating to electronic confirmations. We believe that this process has been effective and that the March 2010 industry Commitment letter provides a framework for future stages of standardisation. While we do not feel that an EU legislative solution is needed to progress greater standardisation and operational efficiencies for OTC derivative markets, we would, however, support regulatory driven initiatives analogous to the industry Commitment process in the US, with a possible role for the European Securities and Markets Authority in setting standards. However, given the global nature of OTC derivative markets, we strongly encourage European policy makers to consider the global implications when designing future standards.

Should EU policy makers choose to mandate aspects of standardisation, for example, by requiring the use of electronic confirmation systems, it is important that they recognise that a standard of 100% coverage is unlikely to be attainable, nor would it be desirable. We acknowledge and would welcome the enormous benefits associated with increased use of electronic confirmation systems in terms of productivity and straight through processing. That said, the use of electronic confirmation systems will be constrained by corporate end users with low volumes of business that would find the cost of joining such systems prohibitive in relation to the volumes confirmed. We also have concerns for the need for corporate end users to retain the flexibility provided through non-standard contracts to hedge their bespoke risks.

We urge policy makers not to view standardisation as a stand alone objective nor as a mechanism for increasing exchange trading of derivatives. We agree with CESR that there are limits to standardisation. Non-financial as well as financial firms will continue to require bespoke products for risk management purposes. Forcing end-users to assume more basis risk by reducing the number of traded contracts will increase risks directly. There could also be unintended consequences, thereby increasing risk to the system, should corporations begin to view hedging as a profit centre (rather than a risk management activity). Placing severe constraints on the ability of corporates to hedge their risks could also undermine the competitive position of corporate end users in the EU.

Standardisation of contracts is not of itself sufficient to justify mandating use of exchanges. There also needs to be sufficient liquidity in those contracts. Whilst a limited number of mandated contracts might increase liquidity, this is likely to increase risk through end users being unable to exactly hedge and leaving themselves open to basis risk. Foreign exchange and interest rate swaps are examples of non standardised products that are highly liquid and easily valued (under normal market conditions).

Platform Trading

RBS recognises the potential benefits associated with trading derivatives on exchanges and organised trading platforms, including transparency, price formation, operational efficiency and market access. However, we do not believe there is compelling evidence suggesting that the financial crisis could be attributed to market failures arising from a lack of trading on organised trading platforms. We do acknowledge that there was a lack of transparency around certain structured products but these would be unlikely to be standardised and therefore would not be traded on exchange platforms. We are, therefore, sceptical of the systemic risk reduction benefits of mandating or incentivising the use of a particular trading platform(s). We are concerned that regulatory intervention has the potential to distort the market with limited benefits.

We support the use of organised trading venues where warranted by market liquidity and customer requirements. However, we also believe that policy makers should define trading platforms broadly to enable market participants to gravitate toward those platforms that best suit their needs. Policy makers should also recognise that trading platforms are not the only mechanisms for satisfying regulatory objectives. For example, objectives of transparency and efficiency can be achieved through other means such as electronic confirmation, clearing, and trade repositories/transaction reporting to provide post trade transparency to regulators and the market. Even among trading platforms, there is a broad range of solutions, many of which are likely to satisfy policy goals. We therefore urge policy makers to be as specific as possible in identifying their policy objectives and expected outcomes. It is also important to recognise the predominantly wholesale nature of the OTC derivatives markets which do not, therefore, require the same degree of protection afforded to retail markets (e.g., equities).

In considering the issue of platform trading, it is critical that policy makers recognise the potential for unintended consequences that could arise were they to mandate a too narrow range of platforms for derivatives trading. Mandating exchange trading, for example, would likely result in a number of adverse outcomes including:

- a reduction of liquidity if market participants refrain from trading out of concern that their trade details would be seen by the rest of the market; and

- increased earnings volatility arising from end-users being unable to qualify for hedge accounting.

We believe there will be a natural evolution toward greater use of more formal trading venues as products mature and become more standardised. Prematurely compelling trading on organised platforms could have adverse impacts, including those noted in the staff report of the Federal Reserve Bank of New York, *Policy Perspectives on OTC Derivatives Market Infrastructures* (no. 424, January 2010):

> "If, however, market participants are forced to migrate to exchanges and electronic platforms too aggressively, then dealers may find that their original costs of innovation are unlikely to be recovered from future intermediation fees. Some useful new or customised financial products may be stifled. This could imply lost opportunities for risk management and, potentially, less market liquidity. Effective opportunities for risk management are important ingredients to economic growth in a broader economy."

Nonetheless, even where platform trading gains traction, it should supplement rather than supplant other less organised forms of trading. For example, in the equity markets much trading is conducted OTC to accommodate the needs of institutional investors with large order sizes, who look to OTC channels to enable them to trade more discreetly and avoid the potential for the market to move against them.

Finally, it will be important that any reforms undertaken by EU policy makers are approached in an international context, recognising again the global nature of the markets and the need to avoid actions that could result in market fragmentation and damage to the EU competitive position.

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