



Deutsche Börse Group

Deutsche Börse's Response
to
CESR
Consultation Paper

on transparency of corporate bond, structured finance product
and credit derivatives markets

Frankfurt / Main, 19 February 2009

Introduction and Executive Summary

Deutsche Börse Group appreciates the opportunity to respond to the CESR consultation on transparency of corporate bond, structured finance product and credit derivatives markets. As we deem transparency to be a prerequisite for market integrity, we very much support CESR's transparent consultation process on this important topic and are grateful for being given the opportunity to provide our views.

Deutsche Börse Group is actively involved in bond and derivatives markets.

- § As regards bond markets, Deutsche Börse AG's subsidiary Eurex Bonds, an inter-dealer bonds trading platform, is an independent trading system that seeks to facilitate liquidity in bonds for the wholesale market. Eurex Bonds plays a specific role in the exchange of securities between primary dealers as well as between issuers and primary dealers. Eurex Bonds operates within a competitive environment comprising both other electronic MTFs and also telephone and broker-based markets.
- § Furthermore, Deutsche Börse AG operates the Frankfurt Stock Exchange where currently about 25.000 bonds are listed and actively traded. These bonds include among others German and European government bonds, bonds of other public issuers (e.g. German federal bonds) and corporate bonds. About 4.300 bonds are listed on the regulated market of Frankfurt Stock Exchange, the remainder are listed on the open market of Frankfurt Stock Exchange (which is classified as MTF according to MiFID). Frankfurt Stock Exchange focuses on retail investors and small / mid size institutional investors.
- § As regards derivatives markets, Deutsche Börse AG's subsidiary Eurex is one of the world's largest derivatives exchanges. Its clearing arm Eurex Clearing AG is the leading clearing house in Europe, providing its customers with high-quality, cost-efficient and comprehensive trading and clearing value chain for derivatives, equities, bonds and repos. Eurex Clearing AG closely follows the debate surrounding a central clearing solution for OTC credit derivatives and has announced its plans to launch a European Solution for the central clearing of OTC CDS contracts in July 2008. Eurex Clearing will be ready to offer the CCP service end of Q1 2009.
- § Deutsche Börse AG's subsidiary Clearstream is the leading European supplier of post-trading services. It ensures that cash and securities are promptly and effectively delivered between trading parties. Over 300,000 domestic and internationally traded bonds, equities and investment funds are currently deposited with Clearstream.
- § As regards market data, Deutsche Börse AG publishes pre- and post-trade real-time market data for all kinds of instruments traded on its markets and on markets of its clients (other market data sources and regulated markets), e.g. shares, certificates, ETFs, derivatives and bonds.

Deutsche Börse Group acknowledge CESR's efforts in responding so quickly to changes which have taken place in the market in recent months as a result of financial markets

turmoil and involving the financial markets industry in consultative discussion on these changes. The financial markets turmoil revealed the importance of transparency for market integrity. More concretely, it revealed the importance of carefully calibrated transparency in the different markets. Cash markets, those being equity and bond markets, are very different from derivatives markets. In cash markets, the degree of standardization is high and price transparency is useful in the sense that it provides valuable information for price comparability to the investor. In contrast, OTC derivatives are tailor-made products where price transparency and hence price comparability is less useful as these products are traded bilaterally, where counterparty risk is much more important. Therefore, while in some markets trade transparency may help to encourage investors to invest, in other markets it is rather a clearing solution that mitigates counterparty risk and thereby helps markets to function smoothly. Both enhance market integrity and investor confidence in these distressed times.

We appreciate that CESR undertakes an analysis of the corporate bond market and structured finance product and credit derivatives markets separately, and we provide a distinguished view on the two markets subject to consultation.

On corporate bond markets:

- § Deutsche Börse Group shares CESR's perspective that smaller market participants and retail investors are considered to have limited access to trading information necessary for their investment decision.
- § Deutsche Börse Group believes that enhanced post-trade transparency would be beneficial to restore investor confidence, help price discovery, facilitate best execution and enhance market integrity.
- § The self-regulatory initiatives currently in place need further efforts. We believe that the market would strongly benefit if real-time data and a far wider bonds instrument scope than currently covered by the self-regulatory initiatives would be provided.
- § Therefore, Deutsche Börse Group would support a regulatory approach to aggregated post-trade transparency.

On structured finance products and credit derivatives markets:

- § Our comments focus on the importance of central clearing to strengthen market integrity and reduce systemic risk. This can be especially valuable and important for the OTC derivatives market.
- § Recent market turmoil has highlighted again the importance of sound market infrastructure for the integrity and stability of financial markets – across asset classes and geographies. Especially credit markets have been hit by a massive breakdown with negative spill over effects on the financial market and industry as such.
- § Central counterparty clearing is a stabilizing element – together with an effective risk management service it reduces systemic risk, improves transparency and operational efficiency.

- § We understand the current discussion of European authorities with the first priority to introduce CCP clearing for OTC credit derivatives¹.
- § As a second priority, CCP trade registration functionality can be leveraged and product coverage could be expanded, e.g. for trade warehousing and as an optimum to enable for central clearing and effective risk mitigation.

We elaborate on these points in more details below.

¹ Please see Council Conclusions on clearing and settlement from 2 Dec 2008 (http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/104451.pdf) and EU Commissioner McCreevy's statement on reviewing derivatives markets, 17 Oct 2008 (<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/538&format=HTML&aged=0&language=EN>).

Detailed Remarks on Part I: Corporate Bonds

In Germany, there is no mandatory pre- or post-trade transparency for bond markets. As noted in the Consultation Paper, Germany chose not to exercise the option under Recital 46 MiFID. Post trade transparency for exchange based bond markets is mainly provided via the exchanges and information vendors. However, unlike trading on regulated markets or MTFs, the OTC bond market is perceived to be opaque, as usually mainly those market participants who provide liquidity seem to get access to the relevant trade data.

Recent market turmoil led to significant decrease of corporate bonds trading turnovers on German exchanges. In Germany, only two major players are left to provide OTC quotes for corporate bonds for a significant product portfolio.

However, as it is also recognized by CESR, we understand that the drop in liquidity was not due to a lack of transparency but due to deterioration of market conditions and creditworthiness of issuers. As outlined in our introductory remarks, it is nevertheless worth considering what form of transparency for which markets may enhance investor confidence and help boost liquidity. With this in mind, it is worthwhile to make a distinction between retail and wholesale corporate bond markets.

We share CESR's view that smaller market participants and retail investors are considered to have limited access to trading information on corporate bond markets necessary for their investment decision. There are indications that this is even more the case considering the actual market turmoil. As the price discovery for corporate bonds takes place OTC (via market making or proprietary trading between banks), there appear to be circumstances of information asymmetry:

- § Frankfurt Stock Exchange's "lead brokers", mainly smaller intermediaries, depend on OTC prices (and liquidity). Without OTC price indications (and OTC liquidity) "lead brokers" are not able to execute retail orders on the basis of fair prices.
- § Given the actual market conditions, in particular higher counterparty risks, "smaller" firms are not able to access OTC markets as banks currently seem to be unwilling to trade with small firms. This has significant impact on information transparency for these firms.
- § Smaller investment firms are not able to guarantee to their clients best execution due to limited or expensive access to transparent information.
- § For the same reason, retail investors are not able to verify whether they have been provided with the best possible result for them.
- § Frankfurt Stock Exchange's current discussions with large buy side firms indicate that there is limited access to transparent post-trade information for bond markets also for large institutional investors, like for example fund managers.

The above observations indicate that trading information seems to be available only to

companies actively participating in OTC markets (sell side, market makers and proprietary traders). We think that an enhanced post-trade transparency would lead to a reduction of outlined information asymmetries. Furthermore, under normal market conditions there are several other positive effects on some of market participants:

- § Investors could have more information about the “true” price of a bond.
- § Investors would have more choice to select between different providers.
- § Competition among market makers would lead to narrower spreads.
- § Investors would be able to check best execution policy of their broker or bank.
- § Market participants would gain from greater safety and risk reduction.
- § Risk reduction might have positive impact on the ability to evaluate assets in banks’ balance sheets.
- § Issuers would have the ability to promote their own issues if they are more liquid.

Potential negative effects of increased transparency in bond markets have been brought to CESR’s and Commission’s attention in recent years. In particular arguments against pre-trade transparency for wholesale bond markets highlighting potential withdrawal of liquidity from market makers have been made. We deem it necessary to emphasize that pre-trade transparency is not for free, as it raises risk exposure and potentially widens bid-offer spreads. Investors might suffer as they might not receive the best price, but rather the highest price possible. Quote obligations or agreements between issuers, market makers and trading platforms would most likely be difficult to achieve. The overall result may be significantly higher transaction costs alongside with the reinforcement of illiquidity. Therefore, Deutsche Börse Group recommends to abstain from introducing a mandatory pre-trade transparency regime for corporate bond markets.

However, we do believe that an effective post-trade transparency regime would significantly increase the stability of all corporate bond markets and would contribute to bringing back liquidity on-exchange. The existing self-regulatory approaches to increase post trade transparency in bond markets need further efforts. We believe that investors would certainly appreciate if real-time data and a wider instrument scope than currently covered by the initiatives outlined in the Consultation Paper would be provided. Beyond this, the source of the bonds prices should be stated on the relevant websites as well, to name just a few improvement suggestions. But bearing in mind the current situation in corporate bond markets following the financial market turmoil, we believe that a faster solution is needed for the establishment of market integrity in the corporate bond market. Therefore, we recommend the introduction of a mandatory post-trade transparency in European corporate bond markets which should be harmonized EU-wide. Such a harmonized regime would bring certainty on the compatibility of the transparency requirements with existing rules and regulations, allowing for complete aggregate post-trade data and movements and ensure level playing field in the EU.

Detailed Remarks on Part II: Structured finance products and credit derivatives

We welcome the fact that CESR dedicates a slot to structured finance products and credit derivatives in this Consultation Paper.

Recent market turmoil has highlighted again the importance of sound market infrastructure for the integrity and stability of financial markets – across asset classes and geographies. Especially credit markets have been hit by a massive breakdown with negative spill over effects on the financial market and industry as such. Against this background, we will focus in the following on two aspects which are highly important for stabilization of and reduction of systemic risk in the OTC derivatives markets:

- § European OTC CCP for credit derivatives.
- § European Data Warehouse for structured products and OTC derivatives.

On the European OTC CCP for credit derivatives

The current market turmoil has shown that central counterparty clearing is a stabilizing element for the markets it covers – together with an effective risk management service it reduces systemic risk, improves transparency and operational efficiency.

As a response, Eurex Clearing AG announced its plans to launch a European solution for central clearing of OTC derivatives in July 2008². On 10 Oct 2008, Eurex Clearing AG presented its central clearing solution for credit derivatives³ both to European as well as US authorities.

Eurex Clearing AG firmly believes that central clearing services are the most suitable option to effectively mitigate existing counterparty risk in OTC credit markets and improve market transparency – both elements are key to a sustainable reduction of systemic risk in credit markets on a global scale. Eurex Clearing's central counterparty clearing model has proven resilient and robust for listed futures and options products, especially during recent turbulences in financial markets. Building on this, the solution proposed by Eurex Clearing AG is a European CCP for OTC credit derivatives with the objective to improve the integrity and the stability of European financial markets. By end of Q1 2009, CCP clearing services will be available for credit products that are OTC traded and registered in DTCC's Trade Information Warehouse with a first product focus on Euro denominated index CDS.

We believe that the market will benefit from this solution in numerous ways:

² http://www.eurexchange.com/about/press/press_584_en.html

³ http://www.eurexchange.com/about/press/press_598_en.html

- § *Reduced systematic risk:* The Eurex Clearing OTC CCP takes over counter party risk through trade novation and minimizes financial risks. The CCP enforces a consistent and sustainable risk control, an adequate collateralization of open positions and reduces the gross risk exposure through multilateral netting.
- § *Balance sheet relief:* The introduction of a central counterparty will increase capital efficiency by reduced balance sheet exposure through zero weighting of exposure towards a CCP. This will result in freeing up of credit lines for all participating banks.
- § *Increased transparency:* With the Eurex Clearing's OTC CCP solution in place transparency in position risks is expected to increase significantly through a central instance. A neutral position valuation by an independent institution ensures an early warning function by daily mark-to-market valuation of open risk positions.
- § *Efficiency gains and cost reductions:* Eurex Clearing's OTC CCP solution aims at reducing manual errors through full automation and straight-through processing as well as an efficient use and management of collateral.

On the European Data Warehouse for OTC derivatives

Lately, discussion is emerging on the necessity of a data warehouse infrastructure for OTC derivatives in Europe. The overall objective is to increase risk transparency by registering all open positions in products that are traded bilaterally and are not yet centrally cleared.

Deutsche Börse AG supports this approach. A European Data Warehouse for OTC derivatives would be a major step towards transparency of market and counterparty risks and would strengthen the effectiveness of risk management and market supervision. Trade registration for all OTC derivatives transactions is the foundation for regulatory reporting and the introduction of clearing. In order to respond quickly to the issues in OTC derivatives markets, we therefore recommend the following:

- § First priority is to implement CCP clearing for OTC credit derivatives as requested by EU Commission within the first half of 2009.
- § As a second priority, CCP functionality for trade registration can be leveraged and product coverage could be expanded, e.g. for trade warehousing and as an optimum to enable for central clearing and effective risk mitigation.

Closing remark

Deutsche Börse Group is grateful for having the opportunity to share its views on transparency of corporate bond, structured finance product and credit derivatives markets and remain at CESR's disposal for further discussion.