



## **CESR Consultation (10610)**

### **Derivative Standardisation and Exchange/Electronic Trading**

#### **Response from HSBC**

##### **1. Introduction**

HSBC welcomes the opportunity to respond to this consultation and to contribute to the policy debate on these important topics. We have contributed to, and are supportive of, the more detailed submission by AFME / ISDA / ASSOSIM / BBA.

Partly through central counterparty initiatives, the industry has taken significant steps toward the G20 objective to standardise more OTC business. However, standardisation and exchange trading are not necessary prerequisites for central clearing, rather it is the ability to assess the risk of the products which determines whether clearing is possible.

##### **2. Exchange / Electronic Trading**

**Exchange trading** has an important role in improving transparency, which should lead in turn to greater market efficiency. It is, however, also important to recognise that exchange trading is not a panacea for addressing perceived inadequacies of OTC derivative markets.

While exchange trading is likely to increase transparency, the ambition to retain or improve liquidity is unlikely to be realised. Liquidity cannot be reverse-engineered with forced transparency by mandatory trading on exchanges. In addition, there are many products listed on exchanges already that rarely trade; and in certain circumstances, exchange trading can even potentially reduce liquidity by breaking the contractual link between a financial institution and its client that exists for bilateral transactions.

##### **3. Standardisation**

There are also limitations to **standardisation**, which is a prerequisite of exchange trading, and we welcome CESR's recognition of the importance of:

- an asset class by asset class approach
- the need to retain scope for innovation; and
- allowing firms to continue to create bespoke contracts to meet precise client needs.

**Bespoke products** enable us to respond to our clients' unique risk profiles. With this flexibility we can provide tailored solutions and meet their needs where it is economically unviable to use standard products. If banks were only to have access to standardised instruments, there would also be an increased concentration risk on one side and unhedged risk on the other, exacerbating the overall levels of risk in the system.

Like other financial institutions, HSBC is drawing on its expertise and is actively engaged in the process to find viable solutions to standardisation. We have been working on standardising our **operational processes** for several years, with dedicated and well resourced project teams. For example in the areas of electronic confirmation, matching and STP, legal terms (notably work done on ISDA documentation) and the process of collateral management including portfolio reconciliation, resolution of disputes, and regulatory reporting.

However, we do not believe that standardisation is appropriate in all cases, particularly if it would be likely to result in significant financial risks being retained in the non-financial sector which is more lightly regulated.



To govern the process of standardisation as it evolves and to enable effective prioritisation, we believe that regulators should actively consider:

- the objective of the standardisation;
- the type of market weakness or failure the particular measure is intended to address;
- the most efficient tool to address this issue, where it should be applied and whether it should be modified for a particular asset class; and
- whether the demand for standardisation and/or exchange trading is being driven by an interested party.

We would like to highlight that there are already very different levels of standardisation in place across individual asset classes – strengthening the case for an asset class by asset class approach. Cash equity markets have seen the greatest move towards standardisation and exchange trading, but there are still many areas in which significant differences remain in the EU. These include:

- Member State competent authorities' discretion in certain areas sometimes leaving markets inefficient and confused;
- different types of market participants and the different nature of products dictating regulatory frameworks that are suitable only for those markets
- fragmented clearing increasing operational risk
- fragmentation of data making regulatory analysis more onerous

Following the introduction of competition between exchanges and alternative trading venues, these differences are likely to increase – creating regulatory imbalances.

In addition, the evolution of equity markets demonstrates that it is possible to have a fully standardised and liquid on-exchange market, but still to have demand for off-exchange / OTC trading.

Where transactions/products are still live and not matured, the cost-benefit analysis is unlikely to justify the application of new rules to those transactions/products. For example, re-constructing standardised products out of existing CDS or ABS add little value and they should be left to mature in due course. HSBC therefore believes that grandfathering should be permitted for such transactions/products.

### 3. Scope

We believe that the scope should be carefully defined in order to find a tailored response that reflects the differences between asset classes. Moreover, as the following illustrates, certain products should remain outside the scope of mandatory standardisation and regulation.

For example, **Vanilla Equity Options** are straightforward products, the markets for which are already efficient and which pose limited market risks.

HSBC is also concerned about the inclusion of products such as **FX forwards and FX swaps** whose values are not contingent upon any future outcome affecting the value of the underlying asset. We believe that such products, although traded OTC, should not be subject to regulation that is being designed for derivatives. The definition of an OTC derivative therefore needs to be carefully drawn and limited in scope.

The paper recognises the netting benefits of on-exchange business and the potential of this to affect the statistics. Particularly, we note that a very significant proportion of the equity derivative market is already traded on exchange, so the cost benefit of migrating more of this



business onto an exchange is likely to be low. Similarly, FX trading already has a wide variety of trading venues, increasing existing overall levels of liquidity and transparency.

**CDSs** are already largely standardised and now cleared through CCPs. As the CESR paper recognises, this is a positive outcome of an industry-led initiative. With CCP clearing already contributing to visible progress in the standard of risk management - requiring mandatory on-exchange trading becomes increasingly redundant.

#### 4. Supplementary Points

We support initiatives for standard legal terms and ISDA documentation provides a broad framework for this. However, we recognise that **legal standardisation** has certain limitations, for instance, it is worth noting that according to a study done by the French Association for Corporate Treasurers, French corporate contracts are split between the FBF master agreement (54%), the ISDA documentation (35%) and the Euro master agreement (11%). A similar situation exists in other European countries. Although the various legal clauses do not strongly differ, there is some divergence, especially in terms of applicable law. More work is needed to reconcile jurisdictional variations to create truly global markets.

We support the **electronic confirmations** process where take-up is already very high. The industry is working very hard to raise levels further, particularly in equity derivatives where the complexity has meant that take-up is slower. Some consideration should be given to transactions done by SME's and more generally by non financial entities where the cost/benefit of requiring electronic confirmation may be questionable.

Although the trading **relationship between banks and brokers** is largely electronic, the settlement of invoicing is currently still largely paper-based and this should be a priority for further electronic standardisation.

We support **contract fungibility** where this is relevant and this is already well underway in certain markets such as interest rate derivatives.