

16th August 2010

## **CESR Consultation Paper Standardisation and exchange trading of OTC derivatives**

### **FBF'S RESPONSE**

#### **General remarks:**

**The French Banking Federation (FBF)** represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, *i.e.* more than 500 commercial, cooperative and mutual banks. They employ 500,000 people in France and around the world, and serve 48 million customers.

First of all, the FBF welcomes the opportunity given by CESR to give its views on the different aspects contained in this consultation regarding standardisation and exchange trading of OTC derivatives. Moreover, the FBF would like to emphasise that French Banks are committed to support all initiatives which will satisfy both their clients' needs (which imply tailor-made solutions for them) and the integrity and soundness of the whole financial system, in order to prevent any systemic risk.

However, at the same time, the FBF would like to express its disappointment about **the short timeframes given to the industry to respond to such major issues** and to the other consultations that are being undertaken in parallel. Such short timing inevitably impinges on the quantity of input that the FBF can obtain from its members, and therefore ultimately also on the quality of the industry's feedback.

#### **I] Standardisation**

##### **Preliminary comments**

The FBF believes that too much pressure to standardise products or to only use standardised products would affect the risk-mitigating abilities of banks relying on derivatives and the ability to specifically design or customize derivatives to address the individual risk profiles (the Capital Requirements Directive – CRD - permits banks to rely on derivative products to mitigate risks). This would also restrict the ability of end-users to manage their risks and would act as a constraint on investment in new projects, with consequent effects on economic activity.

In addition, we believe that standardisation of products should focus on key elements of the product to facilitate automation of processes as quickly as possible. Full harmonisation of products is a much wider exercise and will require significant time with limited additional benefit.

With regards to legal standardisation, there is already a high degree of standardisation as most parties rely on the master agreements developed by banking associations. Besides, we would like to remind CESR of the considerable work which has been done by the financial industry, ISDA and regulators to improve standardisation: publication of new master confirmation agreements for equity derivatives, implementation of the Small and Big Bang Protocols for credit derivatives and electronic confirmation targets monitored by supervisors. Any further requirement for more standardisation should not affect market participants' ability to choose between more than only one type of standardised contract, for example between the ISDA Master Agreements, the European Master Agreement or the FBF master agreements.

The financial industry and supervisors continue to collaborate in several areas such as underlying definitions, confirmation templates and market practices relating to post-trade and lifecycle events.

The FBF approves CESR's opinion on the necessity to improve the level of standardisation in OTC derivative markets but **disagrees that standardisation goes through a legislative process**. Indeed, in order to retain a maximum level of flexibility and the ability to tailor-make products in the OTC derivatives markets, the FBF fully supports a collaboration based on an international and continuous dialogue between the financial industry and regulators. Please note that the FBF considers that despite its useful advantages for the whole market, standardisation is not and should not be a goal per se. Standardisation should only be regarded as a mean to reach the relevant goal which consists in increasing risk mitigation and encouraging enhancement of liquidity.

We also favor continued efforts to develop further **product standardization**, where this is driven by market needs and priorities and taking into account product maturity, liquidity and customer requirements. Products do not need to be standardized in order for them to be liquid, as the market for foreign exchange products demonstrates.

**Q1: Do you agree with CESR's assessment of the degree of standardisation of OTC derivatives? Is there any other element that CESR should take into account?**

The FBF agrees with CESR's assessment of the degree of standardisation of OTC derivatives indicated on pages 12/13.

However we would like to underline that differences should be made between the various classes of assets as for some underlying (such as equities) the majority of derivatives are already standardized and that the remaining part traded OTC, which represent a small proportion, is tailor made by nature.

The industry is already moving toward more standardization while possible. The statistics on electronic confirmation are good example of this move.

ISDA column represent most updated ISDA figures compared to CESR consultation figures:

	cre dit		FX		IR		EQ D	
	CE SR	ISD A	CE SR	ISD A	CE SR	ISD A	CE SR	ISD A
electronically confirmed as % of total volume	92	98	51	54	48	67	23	29
eligible but not electronically confirmed	5	1	19	21	30	20	17	7
not eligible	3	1	30	25	22	13	60	64

**Q2: Do you agree with the benefits and limitations of standardisation noted above? Please specify. Can you also describe and, where possible, quantify the potential impact of the limitations to standardisation? Are there any other elements that should be considered?**

We broadly agree with the description given by CESR of the benefits and limitations of standardisation.

Moreover, the FBF highlights the difficulty resulting from the risk of « imperfect match » between the underlying product and the derivative contract (underlined by CESR) where the resulting costs would in principle be borne by the end-users. For example, this is particularly true with respect to commodity derivatives contracts providing multiple references of terms and quantities.

**Q3: Do you agree that greater standardisation is desirable? What should be the goal of standardisation?**

The FBF fully supports a greater standardisation that would contribute to the efficiency and the liquidity of the markets, and allow optimal allocation of capital in the economy. Nevertheless, the FBF would like to draw CESR's attention on the following major points:

- Standardisation shall not be mandatory and shall only be used only as a means to achieve greater efficiency;
- It shall mirror exactly and permanently the needs and preferences of the markets, as there will always be a significant and legitimate demand for bespoke products from financial and non financial firms;
- A cooperation between regulators and market participants shall be implemented in order to reach an international consensus that would clearly define what standardisation means and involves, on an asset class by asset class basis.

**Q4: How can the industry and regulators continue to work together to build on existing initiatives and accelerate their impact?**

As explained above, the financial industry and the regulators have worked well in the past in the context of OTC derivatives standardisation. The FBF is of the view that, in order to remain effective, this cooperation would be best maintained in the absence of pre-determined regulatory objectives that may primarily see standardisation not as a means in itself but as a means to overrule market preference with regard to execution or clearing venues for OTC derivatives transactions.

**Q5: Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.**

The FBF is of the opinion that, at this stage, there are no significant legal obstacles hindering the improvement of standardisation for OTC derivatives product.

Nevertheless, we would like to insist on the necessity of maintaining an ongoing dialogue with the financial industry as stated above. As a matter of fact, standardisation, as a 'market-led' process, comes naturally with the development of financial markets. Such an evolution shall not be curtailed by a too pre-determined process, preventing, for instance, the market participants choosing between more than only one type of standardised contract: ISDA, European Master Agreement (EMA), or any of the national master agreements such as the agreement developed by the FBF on OTC derivatives.

**Q6: Should regulators prioritise focus on a) a certain element of standardisation and/or b) a certain asset class? Please provide supporting rationale.**

There is a strong probability that legislation removes the possibility for market participants to naturally evolve towards their needs and desired degree of standardization.

Moreover, it might be very complicated to establish guidelines on where standardisation should be more appropriate.

However, the FBF supports further standardisation of the legal framework of OTC transactions to the extent feasible and desirable. With this in mind, we favor an asset class by asset class process, given that the elements of standardisation might differ among asset classes.

**Q7: CESR is exploring recommending to the European Commission the mandatory use of electronic confirmation systems. What are the one-off and ongoing costs of such a proposal? Please quantify your cost estimate.**

We encourage the use of electronic confirmation systems in the context of transactions between financial institutions. A tremendous work has already been done in this specific area and we do recognize that electronic confirmation systems provide tangible benefits across the market.

With this in mind, we stress that:

- we are not convinced that even in the context of transactions between financial institutions a 100% mandatory requirement is necessary in order to achieve the desired regulatory goal. We would prefer a system of incentives where each financial institution would be encouraged to comply with the new requirements and, if it fails, to justify the reasons of this failure ("comply or justify"); the situation is different in the context of transactions in which one of the counterparties is not a financial institution. Indeed, if electronic confirmation systems are widely used among the main derivative dealers, many end-users – corporate as well as financial users – are not equipped with the appropriate tools to electronically confirm their transactions. Therefore, a mandatory use of electronic confirmation systems might involve a substantial cost for, especially for small end-users who do not use derivative products on a regular basis. As a result, it appears to be difficult to contemplate an obligation to use electronic confirmation systems for them, as this may deter many users from using derivative products due to the cost of equipment implied.

## **III] Exchange trading**

### **Preliminary comments**

First and foremost, the French banking industry would like CESR to give **a clear definition of exchange trading**.

The FBF is of the opinion that equity markets are specific markets; as a result, it is not appropriate, not to say counterproductive to transpose the equity model to the OTC derivative markets for the following reasons:

- unlike equities, derivative markets are primary markets where the level of secondary trading varies considerably among classes of derivatives, and may even be inexistent. Investors tend to have more of a buy-and-hold approach in respect of derivatives;
- The investor base for derivative products is almost entirely limited to institutional investors;
- The number of customised derivative products issued by a dealer is almost infinite, and the atomicity of derivative markets is not comparable to the equity market;
- If liquid derivatives currently traded over-the-counter are moved onto exchanges/public trading venues, this could have a negative impact on liquidity and

market making activities, and the consequences for the real economy / the financing of large European corporates may be massive.

We fully support the analysis of the FSA and the UK Treasury on OTC derivative trading:

*[...] mandating trading on organised markets would prove detrimental as:*

- i. OTC markets allow for a variety of specifications of contracts to be traded. This enables hedging of specific risks and the management of risk in a way that would not be possible through the use of standardised exchange traded contracts. Reducing the ability of market participants to fully hedge an exposure would be a detrimental outcome of the current focus on OTC markets.*
- ii. It would severely impact some of the OTC market, as there is insufficient liquidity in some contracts to sustain trading on organised markets.*

*Moreover, mandating the trading of standardised OTC derivatives on organised trading platforms is unlikely to deliver benefits which would warrant the costs of introducing such a policy proposal when regulatory objectives can be achieved by other means. We urge legislators to thoroughly consider this before introducing regulations that could significantly alter the structure of the market. [p 29].*

**Q8: Do you agree with the assessment done by CESR on the benefits and limitations of exchange trading of OTC derivatives? Should any other parameters be taken into account?**

The main issue here, followed by both regulators and market participants is to contribute to efficiency of the derivatives markets.

Accordingly, the FBF believes that moving the derivatives from OTC trading to exchange trading might be appropriate and only viable for products that already are highly standardised or that are linked directly to underlying products traded on exchanges (for example, equity options).

Regarding the pros and cons of exchange trading listed by CESR, the FBF thinks that the description of the limitations is quite incomplete. Indeed, it should include the issues associated with exchange membership and trading fees. Furthermore, if exchange trading were to be mandatory or imposed, there would be a **huge loss of flexibility to use bespoke products**. Indeed, to list a derivative does not mean that the contract will automatically benefit from a large interest for the end-users and then capture liquidity ( eg :on NYSE LIFFE Paris, the Rapeseed Oil contract was finally delisted whereas OTC Swaps on Rapeseed have continued to be traded with large volumes). Many examples could illustrate the fact that liquidity and transparency are important on OTC market only because end-users prefer to buy tailor-made products that are not offered on exchanges on OTC market as they better match their needs.

We support regulators having greater access to information on transactions through the use of trade repositories, central counterparties for cleared transactions or, where appropriate, transaction reporting to regulators. However, the increase of post-trade transparency to the market, as a whole, needs to be carefully weighed against the serious potential impact on liquidity.

**Q9: Which sectors of the market would benefit from/be suitable for (more) exchange trading?**

The FBF does not think it is possible at this stage to identify the sectors of the market that would be « suitable » for exchange. Nevertheless, we can notice that there are already many derivative contracts listed on exchanges regularly used by commercial and financial users but this does not guarantee success if end-users prefer using bespoke products.

**Q10: In your view, for which sectors of the market will increased transparency associated with exchange trading increase liquidity and for which sectors will it decrease liquidity? Please specify.**

Transparency is also linked with liquidity whatever the venue. As a result, if there is no liquidity on a contract, there will not be transparency either. At this stage we have not identified any particular market sectors where increased transparency would increase liquidity as it depends, above all, on the needs of end-users.

**Q11: Do you identify any other elements that would prevent additional OTC derivatives to be traded on organised platforms?**

Apart from the needs of end-users described above, no.

**Q12: How should the level of liquidity necessary/relevant to exchange trading be measured?**

To anticipate a simple measure of liquidity in order to assess whether exchange trading is feasible, is not possible. It just consists in listing the contract and then seeing if users want to trade it on exchange.

**Q13: Do you agree with CESR's assessment of the characteristics and level of standardisation which are needed for a contract to be traded on an organised trading platform?**

The FBF agrees that a sufficient degree of legal, process and product standardisation is needed to support trading of OTC derivatives on organised trading platforms.

**Q14: Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.**

No. There are some instances where OTC derivative contracts which are eligible for clearing may not be eligible for trading. CCP clearing is not an essential pre-condition for the use of organized trading platforms.

**Q15: Is contract fungibility necessary in order for a derivative contract to be traded on an organised trading platform? If so, which factors would be necessary to achieve full fungibility, not only within the same market but across different execution venues? Please provide supporting rationale.**

The FBF believes that contracts fungibility plays an important role in a clearing context but does not identify how it may be a factor improving trading on an organised trading platform.

**Q16: Which derivative contracts which are currently traded OTC could be traded on an organised trading platform? Please provide supporting rationale.**

The FBF insists on the fact that the moving from OTC to organized trading platforms shall not be a mandatory process.

**Q17: Please identify the derivative contracts which do trade on an organised trading platform but only to a limited degree and could be traded more widely on these types of venues.**

Asset classes that are prone to standardisation could be in principle suitable for increased trading on an organised trading platform. For example, many credit derivatives are standardized from a legal and product uniformity point of view and are subject to reasonable degree of process automation.

**Q18: In the OTC derivatives context, should any regulatory action expand the concept of “exchange trading” to encompass the requirements set out in paragraph 86 and 87 or only the requirements set out in paragraph 86? Please elaborate.**

The FBF would like some clarity as to the reason why CESR analyses the Commission's October 2009 Communication and, notably, as to why CESR evaluates what kind of trading meets a number of Commission's – (loosely) established criteria on “aspects of exchange trading that provide added value to central clearing” (para 86). The FBF underlines that clearing (and clearing eligibility) and exchange trading viability (or trading in electronic platforms) are different processes.

The core issue here is what regulatory framework should govern OTC derivatives trading and whether it is appropriate that such framework is fully MiFID-compliant. In this regard, the FBF believes that trading of OTC derivatives could benefit from a looser interpretation of the concept of “exchange trading” as currently enshrined in MiFID and, as a consequence, exchange trading of OTC derivatives would not necessarily call for the set of “organised trading functionalities” described in para 87.

There is a need for specific definition of « exchange trading » in the OTC derivatives world that may differ from the current MiFID definitions.

**Q19: Do current trading models and/or electronic trading platforms for OTC derivatives have the ability to make pricing information (both pre- and post-trade) available on a multilateral basis? Please provide examples, including specific features of these models/platforms.**

There is a variety of pricing information that is available under existing trading models.

**Q20: Do you consider the SI-regime for shares relevant for the trading of OTC derivatives?**

The SI regime has not proved its value in relation to equities trading. The SI regime does not seem to be an appropriate model and adapted to the trading of derivatives.

**Q21: If so, do you consider that the current SI-regime provides the benefits described above which ‘exchange trading’ may offer or are amendments needed to the SI obligations to provide these benefits to the OTC derivatives market?**

No.

**Q22: Which characteristics should a crossing network regime, as envisaged in the review of MiFID, have for a crossing network to be able to be qualified as a MiFID “organised trading venue”?**

It is unclear how the discussion of crossing networks is relevant to OTC derivatives.

**Q23: In your view does the envisaged legislative approach in the US leave scope for regulatory arbitrage with the current EU legislative framework as provided under MiFID? Would regulatory measures taken in the EU to increase ‘exchange trading’ of OTC derivatives help to avoid regulatory arbitrage?**

We would like to stress out that a large part of the US regulation has been left in the hands of the regulators, especially the SEC and the CFTC. This is particularly true for OTC derivative matters, including the definition of “exchange trading”. Therefore, it is highly difficult to speculate at this stage on the various platforms that will be encompassed by the definition of exchange trading.

However, this is essential that EU and US regulators discuss these issues together as a high degree of convergence will be needed for the users to avoid regulatory arbitrages or conflicts of law.

**Q24: The Commission has indicated that multi-laterality, pre- and post-trade transparency and easy access are key aspects of the concept of “on exchange” trading. Do you agree with CESR applying these criteria in its further analysis of what this means in the EU context, in particular in applying MiFID to derivatives trading?**

As already noted, there is a continuum of different kinds of execution models. The Commission has indicated its preference for a particular model, which will be suited to some markets but not others.

**Q25: If not, do you consider that MiFID requirements and obligations should be refined to cover deviating characteristics of other electronic trading facilities? Please elaborate.**

This would only be necessary if it was desired to regulate other kinds of execution model.

**Q26: Are there any market-led initiatives promoting ‘exchange trading’ that the regulators should be aware of?**

No.

**Q27. Which kind of incentives could, in your view, efficiently promote greater trading of standardised OTC derivatives on organised trading venues? Please elaborate.**

As already stated above, the FBF is of the view that, if necessary, the move to listed derivative contracts shall be a market-oriented process driven by the needs of the clients. There is no interest in promoting a greater trading of derivative products on organised trading venues if this reduces the interest of the derivative products for the clients.

The platforms themselves also need to assess whether there will be sufficient volume to justify offering the product.

Therefore, the FBF is against any regulatory incentive. Prohibitions or restrictions would probably lead to less than optimal outcomes.

**Q28. Do you believe there would be benefits in a mandatory regulatory action towards greater trading of standardised OTC derivatives on organised venues? Please elaborate.**

No. The FBF does not believe there would be benefits in a mandatory regulatory action towards greater trading of standardised OTC derivatives on organised venues. There are legitimate reasons why market participants wish to enter into bilateral transactions or use other execution models such as electronic trading. Standardisation, as explained above, shall remain a market-led process.