Aviva Investors' response to CESR consultation on standardisation and exchange trading of OTC derivatives
August 2010

Aviva plc is the world's sixth-largest[1] insurance group, the largest insurance services provider in the UK and is one of the leading providers of life and pension products in Europe and is actively growing its long-term savings businesses in Asia Pacific and the USA. Aviva's main business activities are long-term savings, asset management and general insurance.

Aviva Investors is the global asset management business of Aviva plc, managing assets in excess of £248[2] billion across a range of real estate, equity, fixed income, money market and alternative funds. The business operates under a single brand with over 1,300 employees in 16 countries across North America, United Kingdom, Continental Europe, and Asia Pacific. We are dedicated to building and providing focused investment solutions for clients which include local government organisations, pension funds, wholesale and retail banks, insurance companies, charities and private wealth managers.

General comment

We consider that the industry has made good progress thus far in initiatives to improve the safety and soundness of OTC derivatives markets. However, we believe that already, the industry is at capacity with work taking place as fast as it can and that there is a limit to how much more can be pushed through in the remaining time to the end of 2012. We are concerned that we are attempting to force 5-10 years of change into 2-3 years. We believe that resolving the current industry issues with the proposed CCP and trade reporting initiatives will go some way to delivering some of the objectives of governments and regulators. There is a risk that spreading the focus too thin will not deliver the benefits aimed for. We therefore are asking for a greater amount of time to implement a more considered and effective solution. In the rush to make derivatives markets more safe, we must ensure that the solution does achieve the right degree of safety, is without unintended consequences and we are not forced to live with a solution that meets neither the original requirement nor can adapt to future developments.

Please find below our responses to the specific questions raised. Please note that we ask for our submission to remain private and therefore, not be made available for public inspection.

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?

We agree with the assessment, but would like to ask CESR to consider that it is not only non-financial institutions that would be limited in their hedging opportunities and potentially exposed to basis risk. Pension funds in particular enter into OTC transactions for the purposes of hedging their liabilities. This is a key issue being faced by the CCP initiatives. This must therefore be borne in mind.

[1] Based on gross worldwide premiums for the year ended 31 December 2009
[2] As at 30 June 2010

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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 have no additional comments regarding the benefits detailed by CESR. However, as an asset management firm, we consider there to be further limitations to standardisation. As noted above, there is and will continue to be the need for some variation and customisation of OTC transactions to meet the individual hedging needs of different firms. Understanding where the distinction exists is an important step that must be overcome. Additionally liquidity of all OTC instruments may not exist to the extent it currently does via bilateral arrangements. Analysis should be undertaken to determine what level of liquidity improvements can realistically be achieved. A similar point has been raised by us with regard to CCP i.e. what level of liquidity supports a transaction being deemed as standardised?

Other aspects that should be considered are the large associated costs that a push for standardisation in lower volume products would entail without necessarily any commensurate benefit. The amount of regulatory change being undertaken in the industry already has stretched resources in all market participants, not least the buy-side institutions such as insurance and asset management companies. Industry-led vendor solutions are still yet to resolve many of the issues raised under the CCP initiatives and, due to inconsistency in approach, will cost the end investors even more.

STP rates in some parts of the industry are still sufficiently low that it would be more expensive for these firms to bridge the gap to meet the level of standardisation, with these costs being likely to be passed on to the underlying investor and without commensurate benefit. Also, the time to implement new systems must be taken into account by legislators.

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

A great deal of progress has already been made by the industry in terms of standardisation. For vanilla products (e.g. IRS and CDS), there is not much more to standardise. For other areas, property total return swaps for example, whilst they are relatively standardised, volumes are insufficient to justify a significant investment in electronic trading and confirmation systems and it is unlikely sufficient liquidity would be evidenced to support exchange trading. We think that the goal should be to standardise the high volume products which would capture the majority of trading and these already display a higher level of consistency in structure and legal framework.

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

We believe that the industry and regulators are already working well together on existing initiatives. Our concern is that there are already so many initiatives in progress that the industry and regulators will not properly resolve the issues that need to provide the foundation for such initiatives to be a success. The increased financial and operational risks to market participants, as a result of too much regulatory change at once, are likely to be borne by the end clients ultimately. It is necessary to allow the time to implement such significant changes properly.

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

We are not aware of any obstacles that could be removed by regulatory action. Waiting for industry-led solutions to evolve is likely to increase the cost of standardisation and perhaps regulation could speed up this process by forcing standardisation between providers such as CCPs and exchanges first. This would reduce some of the costs highlighted by us in response to the CCP initiatives, but also limit the amount of technology spend to meet the differing solutions.

For us, it is advantageous where investment banks or vendors are able to provide products on a utility basis as is the case with a number of electronic confirmation products which are free for buy-side users.

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

In terms of asset classes, it would seem that most asset classes have already achieved a great deal of standardisation. The obvious exception is equities but CESR has already set out reasons for this in paragraph 44. We suggest that regulators should focus on the areas of highest volumes such as CDS, IRS and equity markets but maintain a proportional response to other markets until such time as volumes become large enough to justify the investment. For some instruments, for example variance swaps, we suggest that, if it is possible to standardise a contract, then it is in fact preferable for these instruments to be listed. The OTC market can then be reserved for truly bespoke products

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 support encouraging the use of electronic confirmation systems but we are concerned that this may become mandatory. We continue to use voice trading for all derivative asset classes, although we do use Markit Wire and Icelink for affirmation of trades relating to IRS and CDS respectively. For smaller market participants, mandatory use of electronic confirmation systems may impose prohibitive costs and there is the risk that this will actually prevent good risk management. There are the infrastructure costs of paying to access a system (for example £100,000 p.a. per system) plus the costs of building links to systems, as well as supporting upgrades/changes. Currently there is little interoperability as platforms exist as silos that cannot talk to other platforms.

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?

We do not agree with the assessment in respect of transparency in paragraphs 63-66. Whilst we accept that there are many benefits arising from the right level of transparency, we are concerned that too much transparency is not beneficial and is likely to impact on liquidity and anonymity in the market place particularly where there is a requirement for large transactions.

We do not fully support CESR's comments on liquidity as the implication is that there is more liquidity on organised platforms than trading OTC which we do not believe is necessarily the case, and may not be if many OTC transactions are forced to move to exchange. They may in fact not be entered into at all.

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

We have no specific comments to make.

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.

We have no specific comments to make.

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

We consider that there are certain advantages to voice broking which would be lost if OTC derivatives could only be traded on organised platforms. Voice broking is important because of the relationship between the participants. A potential trade can be analysed and the impact of altering the parameters discussed. This may result in a better result for both parties. This could not be achieved if an order is simply placed on an organised platform. In addition, we think that the majority of the benefits that legislators and regulators are seeking can be achieved by the use of electronic confirmation platforms and trade information warehouses.

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

We support the comments made in paragraph 78 regarding excessive transparency harming liquidity. We would like to add a further point to consider in relation to liquidity. On entering into, for example a five year CDS, there may be plenty of liquidity. However, over the passage of time, this instrument becomes a four year CDS, then a two year CDS etc and there is less guarantee that liquidity for such instruments will be sufficient. Therefore, it is not possible to guarantee the continued liquidity throughout the life of an initially seemingly very liquid instrument.

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?

We are pleased that CESR recognises (in paragraph 83) that a high degree of standardisation may not be sufficient to successfully support trading on organised platforms and we would give the example of OTC property total return swaps which are relatively standardised but not necessarily suitable for trading on organised platforms due to low volume and liquidity.

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.

We do not consider that the availability of CCP clearing is essential as trades can still be managed bilaterally under an ISDA with a credit support annex. There are single dealer electronic platforms operating currently and these do not link to CCPs, at least not for the buy-side.

Q15: Is contract fungibility necessary in order for a derivative contract to be traded on an organised trading platform? Please provide supporting rationale.

We think that contract fungibility is necessary but this is not a strong view and it may depend on which platform and which instruments. It would be beneficial to have the ability to trade on one platform and settle on another (which would require contract fungibility) but this is not essential.

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

We have no specific comments to make.

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.

We have no specific comments to make.

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.

We have no specific comments to make.

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 multi-lateral basis? Please provide examples, including specific features of these models/platforms.

Our experience with the fragmentation of data, particularly for equities as a result of MiFID, would lead us to believe that the same problems would arise with OTC derivative pricing data. It is therefore difficult to accept that current models or trading platforms would resolve this issue in the medium term.

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

We have no specific comments to make.

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?

We have no specific comments to make.

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

We have no specific comments to make.

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 consider that it would be advantageous if the US and EU regimes could be as similar as possible to avoid regulatory arbitrage but we have no specific comments to make on the two questions.

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?

Yes, we agree they should be key aspects to consider in moving OTC derivatives to on exchange trading.

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.

We have no specific comments to make.

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

We have no specific comments to make.

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

We consider that an appropriate incentive would be the provision of lower capital requirements in respect of derivatives trades on organised trading venues; however this would require coordination with the CCP initiatives. Incentives for exchange trading should not be structured in such a way as to penalise bilateral OTC trading to a degree that prohibits it.

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.

We have no specific comments to make.