INTESA SANPAOLO

International Regulatory and Antitrust Affairs

INTESA SANPAOLO RESPONSE TO CESR CONSULTATION
STANDARDISATION AND EXCHANGE TRADING OF OTC DERIVATIVES
CESR/10-610

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The Intesa Sanpaolo Group is one of the largest European banking groups active on different EU markets both through Banca IMI, its investment bank, and through its subsidiaries based also in the new Member States.
Intesa Sanpaolo is an active market participant on OTC derivatives and bond markets as a market maker and as a trader.

We welcome the opportunity to respond to CESR consultation paper on Standardisation and Exchange Trading of OTC Derivatives and would like to make the following general comments.

General comments

We appreciate the work carried out by CESR in analyzing OTC derivatives markets with the view to implement the commitments taken by the G20 in order to address the shortcomings unveiled by the crisis.

As a preliminary remark, we note that OTC derivatives markets are global in nature and in order to ensure that they continue to operate smoothly across different jurisdictions, it is crucial that any EU regulatory intervention duly takes into account their global dimension and the different solutions adopted by major EU partners. This is all the more important in order to ensure that there is a consistent implementation of the commitments taken at the G20 level and that no arbitrage is possible.

We share CESR's preliminary conclusions, in particular on the need to foster standardization – where possible – through the use of electronic confirmation and on the benefits of moving the trading of standardized products to public venues, where possible. We appreciate that CESR, when suggesting possible regulatory measures, is aware of the need of preserving the flexibility of OTC markets that have allowed innovative financing instruments to the benefit of the economy corresponding to the specific needs of individual investors.

We strongly believe that when addressing shortcomings and failures that emerged in OTC markets during the crisis, policy makers should set clearly defined policy objectives to attain and be aware of the possible unintended consequences that policy choices could have both on the different arrays of market participants and on products. In our view, unintended consequences should be identified from the perspective of overall regulatory reforms underway, including the review of prudential requirements. It should be avoided that new rules, such as the mandatory electronic confirmation, more adversely affect customer driven business, which is customized by nature and cannot be standardized, rather than purely speculative one. Should this be the case, it would be difficult to achieve the objective of making finance servicing the real economy.

Standardization

We share CESR analysis on the concept of standardization and its three components, i.e. legal, process and product uniformity. As already mentioned in our response to the Commission consultation on "Possible initiatives to Enhance the Resilience of OTC Derivatives Markets" – SEC (2009) 914 final, we fully support the goal of process automation and the recognition of the advantages linked to the standardization of legal master agreements.

Process automation is a powerful driver for standardization and the industry has made great strides in adopting process automation such as electronic affirmation and confirmation. We fully support this goal. We have always opted for it whenever platforms and systems are available with the view of improving operational efficiency and therefore reducing operational risks. We believe that process automation should be mainly an industry driven process that inevitably will choose to deal with the most efficient market participants.

As to the legal standardization, we view the standardization of the legal documentation as a powerful driver of standardization and as an essential element underpinning products that are globally traded. The industry is quite active on its own in this field and has a well established track record of achievements in this regard. Recently it has promoted a project aimed at creating market standard documentation applicable across all OTC products and the Intesa Sanpaolo Group is closely involved with it.

As acknowledged by CESR, the ISDA Master Agreement and its associated documents have become the mostly widely used agreement. Therefore, we do not see any need to require the use of standardized agreements, since the market is moving in that direction on its own.

As to product standardization, while we agree on the benefits related to it, we believe that it should be left to the market forces: when products become more mature and more liquid, they naturally lend themselves to become standardized and to be centrally cleared and traded on exchange. We are concerned that “excessive” product standardization will have the result of stifling product innovation and thus unduly limiting market participants’ ability to hedge their risks and OTC markets’ flexibility.

Accounting rules also play a significant role in OTC derivatives markets: we believe that it is crucial that there is convergence of these rules at the international level so as to ensure that no arbitrage is possible in this area and the buy and sell side can operate on the basis on equivalent rules across different jurisdictions.

Exchange trading

We fully concur with the benefits that trading of highly liquid and standardized OTC derivatives on public venues could bring to the market for the reasons rightly identified by CESR. In this context, we would also add two more: i.e. investor protection and market integrity.

However, we believe that the flexibility of OTC derivatives markets and their ability to create innovative financing instruments tailored to meet the needs of individual investors are valuable assets which should be preserved. Therefore, new rules aimed at reducing systemic risks, improving operational efficiency and increasing transparency on these markets should be crafted in a way that they do not hamper these markets to continue providing financing to the real economy at overall reasonable costs. In our view, OTC and regulated markets should co-exist since they fulfill complementary functions.

STANDARDISATION

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 broadly agree with CESR assessment of the degree of standardization of OTC derivatives.

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 agree with CESR analysis of benefits and limitations of standardization referred in the report. However, as noted in our general comments, we underline the need to preserve the ability of all market participants, i.e. both financial and non financial institutions, to use OTC derivatives to hedge their risks.

Because of the limited consultation period, we are not able to provide data on the potential impact that limitations to standardization may have.

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

The Intesa Sanpaolo Group believes that legal and process standardization should be promoted as much as possible whenever possible, because of the evident benefits that they bring to the market. However, customer driven business can difficultly be standardized, since it is very often tailored to clients' needs of hedging their risks. Any new regulation fostering standardization should not be crafted in a way that penalizes those parts of business that cannot be standardized.

Product standardization should be left to market forces in order not to stifle innovation. Standardization should be a natural evolution of a product and, therefore, should not be mandated.

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

We believe that a dialogue between regulators and the industry remains, even after the crisis, a valid tool for attaining regulatory objectives. It has proved to be effective in the past and should continue in the future within ESMA, which will be entrusted with powers to set draft technical standards.

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

Standardisation should as far as possible be a market-led process. However, we see scope for regulatory intervention when legal and process standardization cannot be achieved because of the existence of national rules preventing them.

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

We believe that it should be up to the industry to work towards achieving to the maximum extent possible legal and process uniformity. As to the latter, for instance in the standardized rate space (IRS, cap/floor,swaption) a lot of progress have already been done in order to achieve more transparency and traceability.

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 fully support – and have already adopted - the use of electronic confirmation systems wherever possible, since it helps reducing risks and post trading costs. We would like to point out that market participants are opting on their own for these systems on the basis of different considerations (e.g. operational efficiency, operational risk reduction), among which the economic one. In particular, the latter one can play a significant role for participants that are not very active on these markets and for which costs connected to electronic confirmation may not be justified. Therefore, from our perspective, we do not see any need to introduce a mandatory requirement.

Moreover, we believe that transactions that are not e-confirmed should be anyhow not penalized.

EXCHANGE TRADING

We fully concur with the benefits that trading of highly liquid and standardized OTC derivatives on public venues could bring to the market for the reasons rightly identified by CESR. In this context, we would also add two more: i.e. investor protection and market integrity.

However, we believe that the flexibility of OTC derivatives markets and their ability to create innovative financing instruments tailored to meet the needs of individual investors are valuable assets which should be preserved. Therefore, new rules aimed at reducing systemic risks, improving operational efficiency and increasing transparency on these markets should be crafted in a way that do not hamper these markets to continue providing financing to the real economy at overall reasonable costs. OTC and regulated markets should co-exist since they fulfill complementary functions.

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 agree with CESR assessment of the benefits and limitations of exchange trading of OTC derivatives and its view that exchange trading and OTC markets fulfill complementary functions. Therefore, in our view policy makers should ensure that OTC derivatives markets and exchange trading can continue to co-exist. In particular, OTC markets should continue to be used as markets for innovative products.

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

Exchange trading can be suitable for products that have high visibility in the market, high volumes, are highly standardized, are centrally cleared, and are perceived to be similar to products that are already traded on exchange. In the credit space, we believe that contracts on credit Index (Itraxx, Cdx) meet all the mentioned criteria. In turn, we do not believe that exchange trading of single name CDSs could be successfully traded on public venues, since - although there are regularly priced - they have not reached a sufficient level of liquidity.

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

We believe that the elements that have been identified by CESR, i.e. standardization, size of the underlying market, size and diversity of market participants, liquidity are the right ones for supporting trading derivatives on exchange.

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

Although products that are highly standardized and liquid are naturally moved towards public venues, should - however - regulators consider fostering this process, we believe that the most effective indicator to be considered for triggering the obligation to trade on a public venue could be the volume of trades, in terms of tickets issued, rather than merely using liquidity as a threshold.

In any case, any requirement by regulators to prescribe “exchange” trading should be made in close consultation with market participants, i.e. both the buy and sell sides, and market infrastructures in order to ensure that all conditions are met in order to make a successful shift. A two stage procedure similar to that provided for in the EMIR consultation paper for the eligibility for the clearing obligation could be envisaged.

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 agree with CESR that legal, process and product standardisation need to be put in place as a precondition for OTC derivatives trading to be moved on organised trading platforms. As rightly noted by CESR, also other factors should be considered namely the size of the underlying market, the size and diversity of market participants, liquidity, CCP clearing availability and contract fungibility.

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.

The availability of CCP clearing is a strong factor fostering and enabling trading on an organized venue. However, the existence of central clearing facilities should not preclude the possibility to trade on a bilateral basis even in the existence of exchange trading facilities. There may be reasons for trading on a bilateral basis rather than going on exchange, in particular when the negotiating fees applied by exchanges are higher than the bilateral ones.

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

We concur with the idea that contract fungibility is an element that facilitates both central clearing and exchange trading. In particular, fungibility enables portability, which we consider as crucial and should be addressed by the forthcoming regulation on CCPs.

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

As already noted in response to question 9, in the credit space we believe that the contracts on Credit Index Itraxx, Cdx are the right candidates to be traded on the exchange, once CCPs will be established.

In the field of standardized rates products, we believe that the following products could be traded on public venues:

- Rates: IRS, Basis swaps, CCS, Swaption, Bond in ASW.
- Inflation:Swap (Y/Y and Zero);

- Commodity products: Swap, European and Asian call and put on energy, base metal and precious;
- Forex products: call and put and vanilla strategies (eg straddle, strangle), fx forward.

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.

Highly standardized contracts can in principle be considered eligible for trading on organized platforms. One of the reasons why trades are still executed OTC is related to execution costs applied by organized venues.

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.

Dealer platforms publish information related to their prices that do not reflect prices of the whole market place.

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

We are not aware of any initiative in this field.

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

We do not believe that specific incentives should be introduced to promote greater trading of standardized OTC derivatives on organized trading venues. We observe that products that become common, i.e. liquid, gravitate on their own towards organized trading venues.

Therefore, greater trading of standardized OTC derivatives on organized trading venues should be a natural evolution of the market.

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.

While we see the advantages of trading liquid and standardized products on organized trading platforms, we do not believe that there would be substantial benefits in introducing a mandatory requirement for exchange trading. We believe that, besides the cases where trading on organised venues is not feasible, there is value in preserving the choice of trading venues introduced by Mifid also in the derivatives market space. As already mentioned, there can be a number of reasons why clients may opt for bilateral trading: costs associated with public trading are one of them. Offering the choice of execution venues spurs competition to the benefit of customers.

For any further comments or questions, please contact:

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