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AmCham EU Position Statement on OTC derivatives markets

INTRODUCTION

The American Chamber of Commerce to the European Union (AmCham EU) speaks for American companies committed to Europe on trade, investment and competitiveness issues. It aims to ensure a growth-orientated business and investment climate in Europe. All of AmCham EU's members have substantial investment and employment interests in the European Union and are therefore firmly committed to the EU's policies and internal market freedoms. AmCham EU aims to ensure an optimum business and investment climate in Europe and facilitates the resolution of EU-US issues that impact business by creating a better understanding of EU and US positions on business matters.

AmCham EU's membership includes some of the most significant financial and non-financial participants in over-the-counter (OTC) derivative markets globally.

While a number of our members have contributed to detailed sector specific responses to the Commission's most recent July 3rd consultation, in this paper we would like to focus on the international dimension of OTC derivative market policy.

AmCham EU has long promoted the convergence of transatlantic financial markets and remains committed to the objective of mutual recognition of securities. The benefits of converged markets is not limited to economic efficiency, but also, crucially, more resilient markets through global supervisory cooperation and exchange of information.

To this end AmCham EU welcomes steps taken by the EU and US to cooperate closely in shaping the global regulatory approach to derivatives markets, through international fora such as the G20, the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO) and the Basel Committee.

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POSITION STATEMENT

THE ROLE OF OTC DERIVATIVE MARKETS

Derivatives markets exist to serve governments, companies, financial institutions and individuals to manage risks more effectively. Whether it is for hedging foreign exchange risk, removing the risk of interest rate volatility or protecting against the default of a counterparty – the ability to hedge risk offers stability of returns for companies, increases investor confidence, and so contributes to the overall health of our economies.

Today these markets are diverse and global – contributing to liquidity of markets, competition between participants, effectiveness of hedging and efficiency for users.

The recent financial crisis has highlighted important areas for market reform, and we welcome targeted initiatives to this end. However, as Europe proceeds with steps to strengthen these markets, it is crucial that we do not lose sight of the very users these markets were designed to serve, the specific nature of these markets nor the potential to generate new risks by well-intentioned actions.

In the section below AmCham EU proposes a number of principles to guide the work of the Commission in its work on OTC derivative markets and prioritises areas for enhanced transatlantic and international coordination as policy work moves forward.

PRINCIPLES FOR OTC DERIVATIVES POLICY

AmCham EU urges the Commission to test Europe's future policy proposals to OTC derivatives markets against the following principles:

1. **Internationally coordinated, consistent and location neutral** – global financial regulation stands at a pivotal moment. The policy decisions taken on OTC derivative markets will set the precedents for the future direction of market oversight – and the quality of trust and mutual reliance between supervisors. The alternative lies in market fragmentation and possible protectionism;
2. **Principles based and risk sensitive** – flexibility is key to regulation adapting to and capturing changes in markets. Formulaic rules risk substantially distorting markets and failing to effectively capture and mitigate risk;
3. **Protecting market diversity** – while fully recognising the need for market reform and reappraising the utility of certain financial instruments, the strength of wholesale financial markets must remain in their capacity to respond flexibly to the needs of users – whether in funding needs or risk mitigation. This too remains key to economic recovery;

4. **Collaboration with markets** – close collaboration between policy-makers and markets is key to effective functioning of regulation. Close collaboration is needed to ensure industry can help regulators to think through potential consequences and ensure a faster time to market for effective regulation;
5. **Effective and proportionate regulation** – the pressure for timely policy responses should not lead to a bypassing of meaningful cost-benefit analysis policy options. The threat of unintended consequences affecting the markets through hastily introduced legislation is high.

AmCham EU is fully supportive of the Commission’s objectives to improve the workings of the OTC derivative markets and broadly believe that the proposals being considered have the possibility of improving the stability of the financial system and its resilience to future crises. However we urge the Commission to remain vigilant as its work progresses to the next policy phase, to ensure any envisaged initiative remains consistent to these principles. Below we detail a number of areas in which these concerns manifest in the current options under review.

1. **Internationally coordinated, consistent and location neutral**

International coordination and consistency will be key not only to preserving open cross-border competition and market efficiency, but also crucially in upholding the very resilience of OTC derivative markets themselves.

AmCham EU is encouraged by the Commission’s initiatives to date to engage counterparts in other jurisdictions, notably the US, to promulgate a consistent framework. We also strongly welcome steps to pursue a coordinated international policy framework at G20 level and through the newly formed OTC Derivatives Regulators’ Forum.

As a minimum, such a framework must ensure similar and appropriate regulatory requirements governing:

- Central counterparties
- Clearing eligibility
- Trade data repositories
- Capital standards
- Recognition of collateral arrangements

Central counterparties

As central counterparties (CCPs) take on an increasingly prominent role in these global markets, AmCham EU believes it is critical to establish high international standards for CCPs. In this regard we strongly support the current work being undertaken to update CPSS-IOSCO standards.

There should not be any possible regulatory arbitrage between CCPs operating in one jurisdiction versus another. CCPs should compete on commercial and service terms, without compromising on risk management standards and

financial robustness. Regulation should therefore define minimum standards for CCPs particularly with respect to margin processes so that CCPs cannot compete on the quality or amount of margin for cleared positions.

Europe, the US and other jurisdictions must recognise that CCPs do not necessarily have to be located within a specific jurisdiction in order to provide effective counterparty risk reduction. While we recognise that CCPs can have potentially important impacts on money supply in the countries in whose currency the derivatives they are clearing are denominated, we would also highlight that there are likely to be multiple regulatory and central bank “stakeholders” interested in supervising the operation of any one CCP. The answer therefore lies in establishing effectively functioning “colleges of regulators” for any CCP, not in segmenting CCPs across multiple jurisdictions. International discussions must also pursue the objective of CCP interoperability, as without it, multiple CCPs will introduce new operational risks and increase fragmentation of risk and margin.

Risk governance of CCPs will also become more important. CCPs mutualise risk amongst members and it is these members that put collateral in place and who are at risk in the process that underpins the functioning of the CCP. As such the determination of membership eligibility must not be left to the CCPs alone. New product clearing should not be a purely consultative process between the CCP’s clearing members and the CCP. Members should be fully involved in the decision to clear products, as they need to be satisfied that the risks can and will be managed appropriately. Eligibility of individual contracts should be determined by the CCP’s risk committee who oversee the overall soundness of the CCP’s risk management process.

Clearing eligibility

AmCham EU supports the greater use of CCP clearing arrangement for products which are “clearing-eligible”. The definition of “clearing-eligible” must factor in the degree of standardisation of defined terms, availability of prices/ liquidity and the ability of the CCP to risk manage the exposures adequately - which may vary over time.

To advance this objective we would recommend establishing a working group within the OTC Derivatives Regulators’ Forum of both regulators and industry, to consider the definition of “clearing-eligible” and its application to the range of OTC derivative products.

Such an approach could articulate the factors which should be taken into account when considering the clearing eligibility of a contract by the CCP and would link to the governance arrangements of the CCP itself and the role of the CCP risk committee.

Trade data repositories

The key value of a central data repository is the provision of a comprehensive trade database containing the definitive record of each contract. It is important for central data repositories to be subject to consistently implemented global regulatory requirements, to ensure that the data can be stored in a single

consistent format and with consistent associated processes. The Commission should therefore aim at ensuring that central data repositories maintain complete, accurate and non-duplicative trade records, with fair access for regulators to the data being stored.

In accordance with the principal of open cross-border competition, there should be a location-neutral policy with regards to the establishment of such central data repositories. If there are separate warehouses by product on a geographic basis, it is critically important for them to be consistent, compatible and interoperable. Multiple reporting formats or requirements will reduce data accuracy and increase implementation time.

The regulatory framework for central data repositories should also consider client confidentiality issues, and in particular any national law restrictions on the ability to report detailed information on client trades.

The OTC Derivative Regulators Forum is currently in the process of finalising a set of reporting requirements for CDS central data repositories; these could be adapted to provide a common set of internationally agreed disclosure requirements for central data repositories active in other segments of the OTC markets.

Capital treatment

AmCham EU strongly supports global harmonisation of regulatory capital charges, due to the global nature of the OTC derivative markets.

It is important to ensure consistent global treatment of, and incentives around, exposures to CCPs; any changes to current approaches should be co-ordinated through global forums. In this context we would highlight the work the Basel Committee is undertaking regarding the current capital treatment of counterparty credit risk, including a separate work stream on CCPs. Given the importance of international agreement on minimum regulatory capital requirements, we urge the Commission to continue to actively engage in shaping an internationally agreed regulatory approach to regulatory capital incentives.

In this regard, we do not support further / new capital penalties for contracts that are not cleared, as these products will continue to play a valuable role in allowing market participants to hedge their risks. The current capital regime differentiates between bilateral and cleared trades and thus provides a strong incentive to clear trades where this is possible. In particular, OTC contracts can generate significant counterparty credit risk capital requirements as a function of the underlying risk of the contract and of the counterparty with which the derivative is transacted.

Recognition of collateral arrangements

The use of collateral as a means of protecting against the risk of default and, for financial institutions, of mitigating capital requirements, needs to be facilitated. The recognition of the effectiveness of collateral in a post-insolvency situation

should be straightforward and clear in order to improve the legal certainty required by those institutions.

This is equally important in the context of providing client access to clearing systems. Enabling the efficient segregation of collateral provided by clients and held by or for clearing members is a key ingredient for the feasibility of this service.

The existence and application of different rules in different jurisdictions in post-insolvency situations is a barrier to the successful and swift resolution of this issue. It would be of particular assistance if the Commission could treat as a priority the harmonisation of these rules.

2. Principles based and risk sensitive

We do not believe that the enforced use of certain types of market structure (such as trading venues or CCPs) is an appropriate response to promote transparency or resilience of OTC derivative markets.

With respect to trading we would instead urge the Commission to remain consistent to MiFID's (Markets in Financial Instruments Directive) framework – which set the global regulatory benchmark for competition between trading venues.

With respect to central clearing, proposals have considered mandatory clearing of all 'standardised' products through a CCP. However the appropriate level of cleared contracts will differ by product, by client segment and over time, and we are therefore cautious of any proposals that may mandate, rather than incentivise, market participants to clear products.

An example of an unintended consequence of mandatory clearing is the consequence of fragmented risk exposures which would limit market participants' ability to hedge exposures effectively. If a client has two products that naturally hedge each other, and one is clearable and forced to use the CCP, a dealer's risk exposure to the client will increase as the hedge is removed. Reducing the ability of market participants to hedge their risk in the most effective way will therefore lead to an increase in risk and increased cost implications for end users.

Mandatory clearing could also potentially introduce unhealthy incentives into the ambition of CCPs to clear new products; it is important to avoid any scenario in which there could be a 'race to the bottom' on product scope or margin. It is also important for CCPs to be able to un-clear products as they become more illiquid and difficult to price and risk manage, as these products can reduce the robustness of the CCP.

We believe that the application of capital requirements must be proportionate to the risks assumed.

Substantial international work within the Basel Committee on Banking Supervision is being undertaken on this topic. Such capital levels should naturally incentivise the use of clearing and the improved coverage and quality of bilateral collateral arrangements.

Of particular note in this regard is that bilateral collateral arrangements have the potential to reinforce market resilience significantly, based on robust dispute resolution arrangements and the regularity of portfolio reconciliations, margin movements and portfolio compressions. As the Commission is aware, there is currently important ongoing work by industry and the OTC Derivatives Regulators Forum to reinforce standards in this respect. The capacity to recognise these high levels of counterparty credit risk mitigation achieved through best practice bilateral collateralisation must be fully reflected in any future revisions to the capital framework.

The five major asset classes of credit, rates, equities, commodities and FX are very different in terms of the risks they face.

We believe it is important that the Commission's proposals are tailored to each of these markets to ensure an effective, but measured, mitigation of the underlying systemic risks.

3. Protecting diversity

Diversity is key to the proper functioning of markets per se.

Diversity is key to markets fulfilling clients' diverse needs and to upholding market resilience. Markets in which participants are forced to act in similar ways are fragile and risks are concentrated. Diversity also permits innovation and development of markets.

AmCham EU understands the objective of increased standardisation for a broad range of asset classes but believe that it is important to recognise that non-standardised products have a critical part to play in allowing market participants to manage their risks.

Standardisation efforts must be directed not to product standardisation but instead focus on (1) greater ***process uniformity***, where these reduce systemic risk (e.g. standardising collateral and margin procedures) or reduce operational risk (e.g. electronic trade confirmation process) and (2) contract ***legal uniformity*** leading to increased legal certainty and reduced operational risks. Product standardization would be counterproductive and importantly would not address the Commission's objectives of reducing both systemic and operational risk.

Non-standardised contracts allow clients to hedge the interest rate risk across any debt repayment schedule, mismatches in currency cashflows, exposure to the commodities that their business produces or consumes, equity risk such as on the issuance of convertible bonds. Many of these are one-off products that play a key part in allowing the corporate users to hedge their risks, but can by their nature not be standardised.

It is clear that corporate users have bespoke risks and need bespoke products to effectively hedge/manage these. In many situations standardisation would work against corporate users performing genuine hedges thereby increasing the potential for systemic risk in the economy.

4. Collaboration with markets

The financial sector has built sophisticated and comprehensive infrastructure to support management of counter-party credit and operational risks, and proposals for change should look to leverage these components where possible.

In addition to industry initiatives to broaden the use of CCPs and support central trade data repositories, steps are already in place to facilitate:

- Faster and automated affirmation/confirmation of all derivatives trades
- Greater use of pre-booking netting -rather than settling on a gross basis
- Wider adoption of portfolio reconciliation
- Wider adoption of portfolio compression to liberate capital and reduce risk

Furthermore, market participants have a key role to play in helping prepare and evaluate proposals, reducing risk of unforeseen consequences and reducing time-to-market of regulation.

5. Effective and proportionate regulation

Caution should be taken to ensure that any proposed changes do not have negative impacts on risk mitigation tools that were deemed to have worked well in the recent market dislocation.

If this were to occur, these unintended consequences could have the potential to increase systemic risk.

The restriction of clients' ability to use products to efficiently hedge their risk may increase the likelihood of wider systemic risk.

With respect to increasing transparency in derivatives markets, whilst full disclosure of trades and positions to regulators is crucial to ensure they are adequately informed, making granular trade information more widely available would bring risks to the operation of the markets (including the ability to execute or hedge large orders), and we would urge that market disclosure

focuses on aggregate positions and post-trade volumes. Increased individual pre- and post-trade transparency brings specific risks that are likely to reduce market liquidity and increase costs for end-users to access the market.

A further area of serious concern lies in the potential impacts of policy proposals on corporate users. Corporate users tend to use derivatives to hedge their cashflow. By forcing corporate users to enter into margin call agreements, such as those required in clearing, the effects would be to create more rather than less cashflow variability, and discourage corporates from hedging their risks.

CONCLUSION

In closing we reconfirm the importance of international cooperation not only in the promulgation of OTC derivative market standards but equally in establishing the necessary trust for mutual reliance in supervision. Priorities for internationally coordinated policy action highlighted include:

- Central counterparty regulation
- Clearing eligibility standards
- Trade data repository regulation
- Capital standards
- Recognition of collateral arrangements

AmCham EU looks forward to playing its part in contributing to the Commission's ongoing work in this regard. At stake is the future smooth functioning of our markets, and with them, our economies.

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