Financial Services Authority & HM Treasury

Reforming OTC Derivative Markets

A UK perspective

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1 Executive summary

Risks highlighted by the financial crisis

1.1 The financial crisis has highlighted deficiencies within the over-the-counter (OTC) derivative markets: most notably shortcomings in the management of counterparty credit risk and the absence of sufficient transparency. This paper sets out the steps required to address these issues, where relevant identifying further necessary work streams.

1.2 In summary, the Treasury and the FSA ('UK Authorities') propose that the following measures need to be implemented and/or developed to address systemic shortcomings in OTC derivative markets:

- **Greater standardisation of OTC derivatives contracts.** Greater standardisation would enhance the efficiency of operational processes; facilitate the increased use of central counterparty (CCP) clearing and trading on organised trading platforms, and support greater comparability of trade information. We will work with international regulators and the industry to take steps to identify and agree which products can be further standardised, both in terms of underlying contract terms and operational processes, and ensure that this is implemented on a timely basis.

- **More robust counterparty risk management.** All OTC derivative trades, whether or not centrally cleared, should be subject to robust arrangements to mitigate counterparty risk. For all financial firms this should be through the use of CCP clearing for clearing eligible products. For trades which are not centrally cleared these should be subject to robust bilateral collateralisation arrangements and appropriate risk capital requirements. This approach may differ for non-financial firms given the different nature of the risks they pose to the financial system. It is important that all participants bear the cost of managing the risk they pose.

- **Consistent and high global standards for Central Counterparties (CCPs).** Increased use of CCPs will heighten their systemic importance so it is crucial that they are regulated to high standards, consistently applied in the major jurisdictions. We are working in CPSS-IOSCO and the Basel committees to revise existing standards. In Europe, the UK has been leading calls for a Clearing Directive and will press to ensure this is an effective tool in mitigating any risk that CCPs will pose to the financial system.

- **International agreement as to which products are 'clearing eligible'.** This will require assessment by both regulators and CCPs in deciding which products are eligible for clearing. In addition to the degree of standardisation, consideration must also be given to the regular availability of prices; the depth of market liquidity; and whether the product contains any inherent risk attributes that cannot be mitigated by the CCP. Once clearing eligible products are identified, regulators should set challenging targets for CCP usage with active monitoring of progress against these rather than mandate the use of CCP clearing.

- **Capital charges to reflect appropriately the risks posed to the financial system.** These should be higher for non-centrally cleared trades and we are working through the Basel Committee to deliver a proportionate approach. Capital charges for exposures to CCPs should also be risk-based.

- **Registration of all relevant OTC derivative trades in a trade repository.** This will facilitate regulators having appropriate access to the information they need to fulfil their regulatory responsibilities. We are working through the OTC Derivative Regulators Forum (ORF) to deliver this across a number of asset classes.

- **Greater transparency of OTC trades to the market.** Access to better information around prices and volumes can help price formation and market efficiency. However, this should be calibrated to minimise scope for an adverse impact on liquidity, and consideration should be given to using existing reporting channels to minimise costs.

- **On-exchange trading.** Once these steps have been taken we do not see at this stage the need for mandating the trading of standardised derivatives on organised trading platforms. Regulatory objectives of reducing counterparty risk and improving transparency can be achieved by other means and we will review progress of initiatives in this area. Moreover, mandating the use of organised platforms would imply a regulatory imposition of trading structure, which we do not believe is necessary.

1.3 This paper sets out our detailed thinking on each of these key issues as well as outlining our approach for taking these measures forward.

2 Introduction

2.1 The financial crisis revealed shortcomings in the management of counterparty credit risk and the absence of sufficient transparency in OTC derivatives markets. Given the importance of OTC markets to the UK economy (43% of the global OTC market is located in the UK)[1] the UK has been leading the analysis of how these issues might be addressed.

I) Counterparty risk

2.2 The default, or fear of default, of a major market participant can have systemic implications, due to the web of relationships between market participants. The default by one party can have a domino effect as the credit worthiness of non-defaulting counterparties is affected. These concerns were experienced throughout the crisis e.g. by market concerns over the solvency of Bear Stearns which resulted in derivative counterparties being highly sensitive to each other's credit risk and the withdrawal of credit lines. As large financial institutions are the main participants in OTC markets the impact in other markets was significant.

2.3 AIG highlighted weaknesses in the management of counterparty risk for bespoke, and therefore less clearable, OTC derivatives. Many of AIG's counterparties had agreed to only require collateral to cover AIG's counterparty risk if AIG were downgraded. When AIG did experience difficulties simultaneous collateral calls and a liquidity squeeze at AIG resulted in its eventual bail-out to avoid systemic repercussions.

II) Transparency risk

2.4 The failure of Lehman Brothers highlighted that positions and exposures of firms in OTC derivative markets were not sufficiently transparent to other market participants or to regulators. This led to an unwillingness to trade, and hence a lack of liquidity.[2]

1 www.ifsl.org.uk/upload/CBS_Derivatives_2007.pdf

2 The EC's 07/2009 paper "*Ensuring efficient, safe and sound derivatives markets*" explains that the opaqueness of the market prevented market participants from knowing exactly what the exposures of their counterparties were to AIG, Lehman's and Bear Sterns resulting in mistrust and the drying up of liquidity in the inter-bank money market.

2.5 More generally, imperfect information also limits a regulator's ability to monitor systemic risks and act to mitigate them, and weak trade transparency for OTC contracts can negatively affect price efficiency.

Legislative proposals for reform

2.6 The regulatory landscape for OTC derivative markets is undergoing great change. On 20 October 2009, following a public consultation,[3] the European Commission published its communication on its proposals for reform for OTC derivatives markets. In the US legislative process has begun with draft Bills currently under consideration. At the global level the G20 issued a communiqué on 29 September 2009 outlining commitments for reform for these markets.[4]

2.7 This paper sets out our detailed thinking on the shape of the regulatory landscape for OTC derivative markets going forward. As the paper outlines, we share the objectives of legislators in both the EU and the US, and we welcome the broad thrust of proposals under discussion. We welcome the opportunity to work closely with our European and international counterparts to ensure that a robust and transparent regime that limits the scope for regulatory arbitrage is introduced. However, we do see some important differences in emphasis between the current proposals and our thinking. We believe some of the measures that have been proposed could have potentially damaging impacts on financial markets. This paper outlines some of our concerns.

2.8. The following chapters set out:

- how greater standardisation of OTC contracts can be achieved;
- how robustly managed CCPs can be effective in reducing counterparty risk;
- how capital has an important role to play in supporting regulatory objectives;
- why the current bilateral collateralisation model needs enhancing and how we are leading work in this area;
- our approach to supporting more transparent markets, both for regulators and for the market;
- how regulatory objectives can be achieved without forcing trade flow through organised trading platforms; and
- how a broad and dynamic approach to position management is an effective tool in deterring market manipulation; and why the evidence does not support the idea that position limits could be used to control commodity prices or price volatility.

3 The Treasury and the FSA provided a joint and public response to the consultation http://www.fsa.gov.uk/pubs/international/response_derivatives.pdf

4 The September 2009 communiqué states: 'All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.'

Progress already made

2.9 Regulators and industry have been working, within Europe and internationally, to deliver change. A comprehensive overview of various workstreams is included in Annex 2 but examples of progress include:

Greater use of CCP clearing for OTC derivatives – The UK Authorities have been involved in securing commitments from major derivatives dealers to increase the use of CCP clearing and good progress is being made against meeting these targets.[5]

Improving standardisation – The International Swaps and Derivatives Association (ISDA) published in April and July 2009 two supplements to its 2003 Credit Derivatives Definitions (the "Big Bang" and "Small Bang" protocols), which adopted the cash settled auction mechanism globally to settle most types of CDS contracts following a credit event and introduced standardised coupons. These changes facilitated the move of the CDS market to CCP clearing.

Improving transparency – the ORF, an international group of regulators, market supervisors and central banks, is close to finalising an international cooperative oversight framework for the global CDS trade repository, the Trade Information Warehouse.The FSA is monitoring progress by industry toward meeting their commitments to introduce global trade repositories for interest rate derivatives and equity derivatives by end-2009 and mid-2010 respectively.

Minimum standards for CCPs – The FSA has also been working as a member of the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions (CPSS-IOSCO) to review existing standards for CCPs in order to better address risks associated with clearing OTC derivatives. And the Financial Stability Board has included this work within its own work programme to reduce the moral hazard posed by systemically-important financial institutions.

5 http://www.ny.frb.org/newsevents/news/markets/2009/ma090908c.pdf

3 Standardisation: Definition, benefits and challenges

The issue

3.1 The diversity of OTC derivative products means they can range from highly standardised to bespoke and complex. When a high volume product is not standardised, it limits the extent to which existing market infrastructure and transparency can be used effectively. This can lead to inefficiencies in price discovery, in the valuation of positions and low use of post-trade operational processes.

Benefits of greater standardisation

3.2 Increased standardisation is central to the delivery of many of the regulatory proposals currently under consideration. Greater standardisation of economic and contract terms will reduce operational risk and facilitate the adoption of uniform post-trade processes, including clearing. It may also contribute to the increased trading of derivatives on organised trading platforms and more meaningful use of trade information by providing greater comparability between products. These measures should in turn lead to more liquid markets.

3.3 In aggregate these market developments would allow participants to trade, settle and monitor positions in a more straightforward way and it could encourage the use, where feasible, of simpler derivatives thereby reducing unnecessary complexity and facilitating more robust risk management.

Role for bespoke products

3.4 While the UK Authorities encourage standardisation, we recognise that a proportion of the OTC derivative market will always reflect demand for bespoke products from firms who want to achieve a desired risk profile. Non-financial firms, in particular, have a legitimate need to transfer their risks using bespoke products. Typically they transfer these risks to financial firms. Financial firms then choose to manage this risk by either dispersing or retaining it. By overly restricting the range of products available, pockets of residual risk may build up. It is important that bespoke products are appropriately risk managed through the use of robust bilateral collateral arrangements and appropriate capital charges (See Chapters 5 and 6 for further detail on this).

The UK position

3.5 Those products with a volume of turnover above a certain threshold should be standardised and subject to straight-through processing (i.e. automated from the point of trade through all post-trade processes) on their trade date. This will reduce operational risk and will facilitate greater use of CCP clearing, trading on organised trading platforms and greater comparability of trade information.

3.6 A significant amount of the legislative debate has focussed on using the term 'standardised' to categorise which products must be traded on exchange and/or cleared via a CCP. However, there are benefits from pursing greater standardisation in itself, irrespective of whether these products are then cleared or traded on an exchange. We support this wider approach to setting universal standards. This may result in products which may be considered to be standardised but are still not suitable for CCP clearing as they do not meet other necessary criteria.

3.7 However, standardisation will mean little if definitions and practices are applied in one jurisdiction and not another. In order to maximise the possible benefits from standardisation, it is essential that an international agreement between regulators and market participants is reached as to what standardisation means and what is realistically achievable on an asset class by asset class basis. Regulators alone are not equipped to make these decisions.

Progress to date

3.8 Considerable work has already been undertaken by industry, some of which was driven by the regulatory push for increased use of clearing, under the auspices of ISDA, with oversight by the international group of derivative supervisors. Focus has been on identifying and implementing changes that will bring about increased standardisation in each of the OTC derivative asset classes. Examples include:

- The publication of new Master Confirmation Agreements for equity derivatives;
- The launch of the Small and Big Bang Protocols for the credit derivatives; and
- The meeting of electronic confirmation targets which are monitored by supervisors.

3.9 Further standardisation is likely to require progress from industry in several areas including underlying definitions, confirmation templates and market practices with regards to post-trade and lifecycle events. Once achieved these will support the overall goal of straight through processing.

Proposed next steps

3.10 Although much progress has already been made, further work remains. In Europe the Commission is considering incentivising standardisation by assessing "whether to reshape the operational risk approach in the Capital Requirements Directive (CRD)". We support the Commission's aims and the FSA is participating in CRD technical working groups to help design proportionate capital charges.

3.11 However, it may prove challenging to design legislation to achieve this objective so the industry and regulators should work together to identify which mature products lack appropriate standardisation, and to determine what is realistically achievable for the asset classes in question. Industry should then commit to undertake the necessary steps to increase their degree of standardisation on a timely basis.

3.12 Where suitable levels of standardisation already exist, we will be requiring industry to commit to challenging targets for post-trade processes in order to achieve the objective of trade date straight-through processing for the majority of such trades. We will require firms to dedicate sufficient resources to meet existing targets and establish increasingly aggressive targets for continued development.

4 Greater use of central counterparty (CCP) clearing

The issue

4.1 An acute sensitivity to counterparty risk, particularly at the height of the crisis, had severe implications for financial markets and resulted in the retraction in liquidity as participants became reluctant to trade with each other. This, in turn, was exacerbated by the significant web of interconnections between counterparties, and led to further negative consequences as participants could not properly access financial markets.

Regulatory solution

4.2 The increased use of CCP clearing for an internationally defined set of 'clearing eligible' products is a key step in mitigating this risk. A CCP can impose consistent and robust risk management practices as well as act as a circuit breaker to the default of a member. In addition, greater use of CCP clearing can aid market liquidity and efficiency, be a motivating force behind contract standardisation, and reduce systemic risk.

4.3 The September 2009 G20 communiqué called for 'all standardised OTC derivative contracts to be cleared through central counterparties by end 2012 at the latest'. The UK Authorities strongly support the greater use of CCP clearing arrangements in OTC derivative markets for products which are 'clearing-eligible'. Furthermore, the UK Authorities agree that challenging interim targets should be set for the industry to meet ahead of the 2012 G20 deadline.

4.4 In order to achieve an internationally-agreed definition of the products which are eligible for clearing by a CCP, we will push for the establishment of an international working group comprising regulators and industry. This group would also need to take into consideration products which are not currently eligible for clearing but may become eligible at a later date.

Clearing eligible versus standardised

4.5 In deciding whether a product is eligible for CCP clearing the sole criterion of standardised is insufficient and would leave CCPs and the market exposed to a number of risks. To ensure that CCPs are able to risk manage effectively consideration also needs to be given to:

- regular availability of prices;
- sufficient depth of market liquidity; and
- whether the product contains inherent risk attributes that can not be mitigated by the CCP.

4.6 Using this combination of factors would enable CCPs to more effectively risk manage the exposures both in terms of calculating appropriate margin calls, and in unwinding positions in the event of a default of one of their members.

4.7 These determining factors should be supported by the appropriate processes for agreeing which products are 'clearing eligible'. In our view this should include regulators working with the relevant market participants to decide which products are clearing eligible. However, CCPs should not be forced to clear a product if they are unable to manage the risk of doing so. Equally, regulators should have the ability to decide a product is not clearing eligible if they are not comfortable with the risk management processes available in CCPs.

4.8 It is for these reasons that we do not support proposals to mandate CCP clearing for all standardised derivatives. Mandating the clearing of all standardised derivatives could lead to a situation where a CCP is required to clear a product that it is not able to risk manage adequately, with the potential for serious difficulties in the event of a default.

4.9 Furthermore whilst we support the use of ambitious and challenging targets for CCP usage for clearing eligible products with close regulatory oversight we do not believe this should be mandatory. For example, there may be some circumstances in which the more appropriate risk management approach is to manage a clearing eligible position alongside a non-clearing eligible position with the same counterparty outside of the clearing house. We also recognise the costs and difficulties that certain market participants may have in accessing CCP clearing, and the impact mandating central clearing could have on them.

Progress made in use of CCP clearing

4.10 Industry has made great strides in the use of CCP clearing for OTC derivative markets and has made public commitments which will ensure greater take up over time. For interest rate derivatives, the G15 dealers have committed, by end-December 2009, to clear 70% and 60% of new and historic trades respectively. For credit default swaps, the dealers have committed to clearing 80% of all eligible trades by October 2009.[6] We are pressing industry to maintain momentum towards meeting these and future agreed targets.

4.11 There are currently three clearing houses that are actively clearing CDS products with others expected to launch services shortly. In addition there are plans to expand product coverage which will mean that a greater proportion of credit derivatives business over time will become eligible for CCP clearing. Supervisors will require the clearing target levels agreed with the OTC Derivatives Supervisors Group to be updated to reflect the expansion of product sets.

6 http://www.ny.frb.org/newsevents/news/markets/2009/ma090908c.pdf

4.12 Other asset classes currently have differing degrees of coverage. For example CCP clearing is relatively well established for part of the interest rate and commodity derivative markets whereas in equity derivatives coverage is less and currently there is no CCP in place clearing FX derivatives in Europe.

4.13 A more comprehensive overview of CCP clearing coverage is in Annex 3.

Non-dealer access to CCP clearing

4.14 Work is also underway at a global level to improve the access of non-dealer ('buy-side') participants to clearing houses. This can be achieved in two ways. First, the non-dealer participants can become direct members of clearing houses. In doing so they would need to meet the participation requirements, including financial requirements, of the relevant clearing house. Secondly, they could become indirect clearing members (i.e. clients of clearing members). This would result in the non-dealer participant having counterparty risk to the clearing member. However, this risk can be mitigated by the segregation of client accounts from dealer accounts, and portability of client collateral and positions (i.e. the ability to move positions and collateral from one clearing member to another in the event of a default of the first clearing member). Such arrangements would encourage a wider range of market participants to use central clearing.

4.15 The UK Authorities agree that all market participants should have access to the benefits of CCP clearing for 'clearing eligible' OTC derivatives, including those participants who are not clearing members themselves. We consider that the availability of segregation and portability facilities would further encourage CCP use and bring other benefits, particularly in how arrangements relating to the default of a clearing member would operate. We are supporting initiatives to make those facilities available.

4.16 Dealers have agreed with the international group of supervisors, including the FSA, that they will have facilities available for buy-side access to CDS clearing, including segregation and portability. The dealers and CCPs are working together to achieve this and regulators are actively monitoring progress against these commitments.[7]

Implications for non-financial firms

4.17 Non-financial firms typically use OTC derivatives as a tool to hedge the risks incurred in the course of their core business. According to the ISDA 2009 Derivative Usage Survey, 94% of the Fortune 500 companies surveyed used OTC derivatives to hedge non-business risks. Whilst the introduction of CCP clearing will assist in mitigating counterparty and interconnectivity risks for systemic firms, there has been considerable concern expressed over moves to mandate the use of clearing by non-financial firms.

4.18 If non-financial firms were forced to clear products, the requirement to post both initial and variation margin to the clearing house or their clearing member would increase costs and introduce an unpredictable liquidity burden. In order to meet their liquidity needs, it is likely non-financials would be dependent on financial firms extending them credit which would then transfer the counterparty risk back to the financial sector rather than mitigating it.

7 http://www.newyorkfed.org/newsevents/news/markets/2009/060209letter.pdf

4.19 PFI/PPP project companies[8] use derivatives in a similar way to non-financial firms (i.e. to hedge risks incurred in the course of their core business). These entities are thinly capitalised special purpose companies and posting collateral would similarly introduce a new liquidity and possibly credit burden. As the public sector is the sole client of a PFI/PPP project company, this will increase the cost for government.

4.20 Whilst the UK Authorities fully appreciate that the main objective of any new derivatives risk management system is to identify and mitigate systemic risks, individual PFI special purpose companies are unlikely to be as systemically important as a major bank.

Preferred approach

4.21 The introduction of CCP clearing is focussed on mitigating the systemic shock that the failure of a major participant would bring about. As set out in the *Turner Review*[9] regulators can not be indifferent to the risks posed by non-financial firms and as such a blanket carve-out from the requirements to mitigate counter-party risk within the financial system does not seem appropriate. All market participants should expect to bear the cost of mitigating their counterparty risk within the system.

4.22 We are of the view that financial firms should use clearing services for clearing-eligible products. Where the entity is not a financial firm or the product is not clearing eligible, firms should as far as possible use bilateral collateralisation to mitigate their counterparty risk. However, if operational or financial resources do not permit this, then firms should expect to be charged by their financial counterparty the cost of the appropriate capital charge under the CRD as a means of mitigating their counterparty risk.

The need for a harmonised regulatory framework for CCPs

4.23 The drive to have a significantly greater proportion of OTC derivatives markets centrally cleared will further increase the systemic importance of CCPs. Moreover, many of the CCP clearing members, i.e. the firms that provide or subscribe to their default funds, would typically be regarded as systemically important in their own right. Against this background, it is essential that CCPs themselves are subject to stringent capital, risk management, margining and operational standards.

4.24 The UK has been leading the call for a Clearing Directive in Europe. We therefore welcome the Commission's proposal for legislation to establish a regulatory framework for CCPs. We believe this should lay down uniform high regulatory standards and enshrine fair and open cross-border access for, and competition between, clearing houses. These standards should align with those to be agreed by CPSS-IOSCO (outlined below).

8 Such companies generally construct and operate infrastructure assets on behalf of public sector clients, raising the required finance (often LIBOR-based floating rate loans) on the back of long-term concession agreements which are predicated on fixed interest rates.

9 http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf

4.25 However, once uniform pan-European standards are in place and national regulators are required to conduct their authorisation and supervisory activities in accordance with such standards, it is unclear what additional benefits the introduction of authorisation and supervision at a pan-European level, as is being considered by the Commission, can deliver.

4.26 It is important to bear in mind that in the most extreme circumstances, default of several of a CCP's members could result in the failure of the CCP itself. As CCPs will be increasing in systemic importance, a failure brings with it the possibility that public authorities would need to step in to provide support, for example acting as lenders of last resort in order to support CCPs during a temporary liquidity problem. An insolvent CCP could impose a direct cost for taxpayers of the home state. It has already been recognised that supervisory responsibility for financial institutions which ultimately may need the taxpayer to stand behind them should reside with the home state.

4.27 As the Commission or a pan European regulatory authority cannot bear the fiscal responsibility in the event of a failure of a CCP, full supervisory responsibility should therefore reside with the home state.

Work in hand at the international and European level

4.28 In line with G20 requests, CPSS and IOSCO have initiated a review of their existing recommendations in order to address issues specific to OTC derivatives. There is also a need for a full review of the recommendations as a whole, to take account of recent market and regulatory developments and to ensure that they remain appropriate to underpin the further development of CCP activity. The conclusions of this work should ultimately be reflected in relevant legislation.

4.29 At the European level, ESCB and CESR have agreed recommendations based on the work of CPSS-IOSCO to include provisions for OTC derivatives. While these recommendations are non-binding, the members of ESCB and CESR have committed to promote and monitor the application of the Recommendations within their jurisdictions.

Proposed solution

4.30 There should be a market shift towards greater CCP clearing of OTC derivatives. The use of ambitious and challenging targets for CCP usage for clearing eligible products by appropriate clearing members with close regulatory oversight is in the first instance helping to achieve this objective and this approach should be continued. In addition, we need to consider the extent to which regulatory intervention may be required to drive more of the market to CCP clearing and how these requirements should apply to non-financial firms. The regulation of CCPs should be reinforced by a robust regulatory framework with home state regulators retaining authority for the authorisation and on-going supervision of CCPs. There should be strengthened global prudential and operational standards for CCPs and these should be reflected in any European legislation.

5 Strengthening risk management for non-cleared trades

The issue

5.1 CCP clearing can be effective in reducing counterparty risk, but due to the variable liquidity of different products within the OTC derivatives market and the legitimate need to access bespoke products, only a proportion of the overall derivatives market will ever be suitable for CCP clearing.

5.2 Where CCP clearing is not available or not used, it is important the two counterparties bilaterally manage their counterparty risk. The near-collapse of AIG is an example where commercial decisions regarding these bilateral arrangements resulted in incomplete mitigation of the counterparty risk. It is therefore essential that steps are taken to ensure that these types of transactions are adequately risk managed. Market participants and regulators should be able to take comfort that in the event of a default of a major market counterparty the contingent exposures have been appropriately collateralised and/or capitalised.

Existing framework

5.3 A legally robust and well-understood framework is already provided by ISDA. It includes a netting agreement (an ISDA Master Agreement) which reduces the portfolio of exposures to one net exposure between the two counterparties and the Credit Support Annex/Deed (CSA/CSD). The latter details the arrangements by which the parties post collateral to each other to cover the out-of the-money exposure should either counterparty default.

5.4 These arrangements effectively mitigated substantial amounts of counterparty risk during the Lehman default and the UK Authorities support their continued use. However, there are areas that could be improved.

5.5 For example, under existing bilateral arrangements some of the issues below can arise:

- As there is a time lag between market moves and the posting of collateral, it is possible unexpected unsecured exposures may arise during volatile markets.
- On some occasions it is possible that the out-of the-money party may post collateral to the other party in excess of the amount the market value of their potential

debt. If the in-the-money counterparty then defaults, this "over-collateralisation" should be returned to the out-of-the-money counterparty but if unsegregated it may become part of the general estate of the bankrupt entity.

- Commercial interests to attract and retain business may influence firms into weakening the provisions of the standard form of the collateralisation agreements resulting in increased retained risk.
- Contractual features such as triggers on credit ratings can result in significant shifts in collateral requirements between parties to a transaction which, in extreme circumstances, can have a destabilising effect.
- As a result of any or all of the above, unsecured exposures, which in aggregate might be systemic, may be opaque to both regulators and market participants.
- Unresolved disputes between the two parties may result in insufficient collateral being posted and incomplete mitigation of counterparty risk.

How to mitigate these risks

5.6 All transactions, whether cleared or not, should be adequately risk managed so that the failure of a major counterparty does not cause a market failure. Such arrangements should not introduce new systemic risks.

5.7 Bilateral collateralisation arrangements must therefore be subject to robust risk management, which should include: regular (preferably daily) valuation and margin call processes; strong legal and operational frameworks; and appropriate capital requirements.

UK position

5.8 The UK Authorities welcome the European Commission's recognition of the weaknesses in the current model. However, in our view its proposals for mandatory posting of initial and variation margin may not fully address all of the risks inherent in the existing arrangements. In addition, they may have negative consequences for firms, especially non-financial firms who might find it difficult to risk manage the unpredictable liquidity burden this would impose and potentially exacerbate existing risks associated with over-collateralisation.

Approach for non-financial firms

5.9 A firm's ability to collateralise exposures relies upon its ability to support the operational aspects of collateral management processes as well as its ability to source and fund unpredictable (potentially large and frequent) margin requirements. Not all firms have equal levels of financial and operational resource to dedicate to this function. Therefore plans for improving the robustness of bilateral collateralisation processes should be structured to ensure that any changes are proportionate to the risk of the users and the sector to the system as a whole.

5.10 As discussed in Chapter 4, the non-financial sector is likely to have significant difficulties managing the liquidity risk of collateralising daily marked to market valuations. This is the case for both CCP and non-CCP cleared business. Given the demand from these participants for bespoke (and therefore non-CCP cleared) products a significant portion of the overall portfolio for non-financial firms is likely to remain under the bilateral collateralisation model and/or mitigated by proportionate capital held by financial firms (see Chapter 6).

Preferred approach

5.11 The UK Authorities view CCP clearing as a lower risk method of mitigating counterparty risk and therefore, in accordance with the G20 communiqué, we support higher capital charges for non-cleared counterparty risk. The UK Authorities would like to see risk-proportionate capital charges being applied to bilateral counterparty exposures in order to motivate firms to adopt the identified best practices associated with bilateral collateralisation arrangements.

5.12 Financial firms should use CCP clearing for very significant levels of clearing-eligible products. For non-financial firms or where the product is not clearing eligible, firms should as far as possible use bilateral collateralisation to mitigate their counterparty risk. However, as outlined in Chapter 4, the non-financial sector is likely to have significant difficulties managing the liquidity risk of collateralising daily marked to market valuations. In such cases bilateral collateralisation may not be a proportionate risk mitigant and these firms could expect to be charged by their financial counterparty the appropriate capital charge under the CRD as a means of mitigating their counterparty risk.

5.13 In our view, regulators need to consider the whole bilateral collateral process and market practices associated with it and how these vary across different market sectors and geographic regions to determine if they meet the required high standards for risk mitigation rather than a narrow focus on the amount of margin being posted.

5.14 The UK Authorities have asked market participants, including dealers, buy-side firms and corporates, to undertake a fundamental review of current bilateral processes with the goal of enhancing the robustness of the current processes, practices and/or infrastructure. Key deliverables are:

- a report in **January 2010** which will provide regulators and policy makers with details on how the existing processes function, identifying risk and proposing the most effective method for strengthening risk management procedures for non-CCP cleared transactions.
- agreement by **March 2010** on a global roadmap for changes to improve the robustness of the arrangements between both industry and regulators; to be implemented by industry thereafter, with international regulatory oversight.

5.15 We look to the Commission and other policy makers to take into account the conclusions of this review before drafting legislation in this area in order to fully address the risks in current processes.

6 The role of capital

The issue

6.1 Regulatory capital is a key tool in mitigating prudential and systemic risks; many key requirements are being reviewed. It is important to set capital requirements to reflect the relevant risks; which ought to also serve to appropriately incentivise the use of CCP clearing.

Current position

6.2 Firms subject to the FSA Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) are generally required to hold capital against the risk that their counterparty defaults. However, exposures to a qualifying central counterparty, with the exception of a default fund contribution, do not currently attract a capital charge. This reflects a desire amongst policy makers internationally to incentivise the use of central clearing as opposed to bilateral OTC arrangements, given a perception that central clearing reduces counterparty risk. At the time when Basel II came into force, it had been agreed that CCP exposures should attract a 0% capital requirement.

6.3 Despite the capital concession, what we have seen amongst regulated firms is a preference in some OTC derivative markets for bilateral agreements as opposed to using a CCP. This might suggest that the current capital requirements have not delivered a sufficient incentive to use CCP clearing, although other factors are likely to be significant.

6.4 The predominant view amongst international regulatory bodies remains that for those products which are clearing-eligible, central clearing, with appropriate oversight, is preferable to the bilateral alternative. The desire then to incentivise the use of CCPs has not diminished, and continues to dominate the international agenda with capital charges for both centrally cleared and bilateral trades currently being discussed under the Basel framework.

The International objectives

6.5 In order to incentivise greater standardisation of contracts and ultimately the greater use of CCP clearing, the Commission has proposed to widen the difference of capital charges between centrally-cleared and bilaterally-cleared contracts in the CRD. This is reinforced by the September 2009 G20 communiqué which agreed that non-centrally cleared contracts should be subject to higher capital requirements than those which are centrally cleared.

The UK Authorities view

6.6 The UK authorities support capital requirements that are proportionate to the risk they assume rather than being used as a tool to directly influence market structure. We therefore agree with the G20 and the Commission that bilateral arrangements, due to their higher risk should be subject to higher capital requirements, but we are not supportive of penal, non-proportionate capital charges.

6.7 Exposure to a well-managed and well-capitalised CCP, should by virtue of its low risk, attract a lower capital charge. Given the mechanics of a CCP default, it must hold that the default of a CCP is less probable than the default of an individual member. Therefore a lower capital requirement for a CCP relative to an OTC exposure is wholly consistent with a risk-based and proportionate approach.

6.8 It is also important to consider that the introduction of a CCP may provide some additional system-wide benefit by acting as a circuit breaker to systemic risk on a major participant's failure. Since this would not be reflected in individual, firm-level capital requirements, a capital concession to reflect this reduction in systemic risk may therefore be optimal.

6.9 That said we believe it is important to consider the tiering of the CCP's capital structure when evaluating the relative risk of different classes of exposure. It is an oversimplification to assume all exposures to a CCP are equal and any capital requirement must acknowledge this heterogeneity and differentiate between exposures whose probability of loss is materially different.

6.10 Contributions to the default fund are intended to cover losses given the default of other clearing members. Given a CCP will exhaust its default fund before it draws on its own capital, the probability of the default fund suffering a loss is substantially higher than the default of the CCP and we consider it appropriate that exposures to the default fund receive a higher capital charge, relative to other exposures.

6.11 From a macro-prudential perspective, higher capital charges against holdings of capital in other financial institutions are also desirable in order to limit 'double gearing' in the financial system. In line with this, current BIPRU rules exempt default fund contributions from a general capital concession in which all other CCP exposures receive a zero capital charge. Instead, we believe contributions to the default fund should be risk weighted like any other exposure in accordance with the relevant BIPRU rules.

6.12 This, of course, is only one side of the equation. Higher capital requirements against non-CCP cleared trades may also be appropriate given evidence suggests that current capital requirements may underestimate the true risk. We support the work within Basel to reviewing the capital requirements against bilateral exposures.

6.13 If properly calculated, risk-proportionate capital requirements should act as a natural incentive for using central clearing, and we support the Basel work designed to increase the risk capture and calibration of the counterparty credit risk framework.

6.14 We support the use of clearing where products can be appropriately managed. However, we are concerned that using disproportionately penal OTC capital requirements to broadly incentivise central clearing could force a significant volume of products, where robust risk management practices have yet to be developed, onto a clearing house. This would centralise systemic risk and could jeopardise market integrity. We would therefore not support proposals to incentivise the use of clearing via the use of penal capital charges. By the same logic, we do not support proposals that argue for mandating the use of CCPs.

Current international work and next steps

6.15 Basel's Policy Development Group (PDG) has tasked the Risk Management and Modelling Group (RMMG) with addressing a number of counterparty credit related issues. The objective is to make the capital charge more sensitive to the factors that drive exposure at default; to require greater capital to be held against OTC exposures; and to continue to provide regulatory capital incentives for the use of central clearing.

6.16 Regarding the likely future capital regime for CCPs, the current view of the Basel working group is that the prudential treatment may be revised to better reflect the true prudential risk of transacting with a CCP. This work is ongoing and the FSA will continue to input into the international discussions.

6.17 The PDG has also tasked the Trading Book Group (TBG) to undertake a fundamental review of trading activities. This work will involve consideration of the appropriate capital requirements for all trading activities.

6.18 The current capital framework for trading activities is focused on the market risk of a product, with counterparty risk considered for OTC derivatives. Aside from the prudent valuation requirements, the current market risk framework makes no explicit distinction between centrally cleared and bilateral trades. In the future it is possible that market risk requirements will give explicit recognition to factors such as the liquidity and price transparency of derivative contracts. Such considerations would clearly have implications for OTC derivatives markets.

7 Greater transparency

7.1 Reducing counterparty risk is not the sole focus of regulatory reforms. The financial crisis has also brought to light many weaknesses in OTC derivative the markets which relate to their opaque nature. The UK Authorities share the view that measures designed to improve the transparency of these markets – both in terms of the information provided to market participants and the information provided to regulators – can deliver a range of efficiency and risk benefits and should be a key objective of the proposed financial reforms.

I) Position transparency to regulators

The issue

7.2 One of the key weaknesses during the financial crisis was a lack of information providing regulators with a clear aggregate picture of the interconnectedness of positions held by the firms they supervise and their potential exposures to market counterparties.

Regulatory solution

7.3 Providing position transparency to regulators via the use of a trade repository would help identify potential sources of concentration risk and market instability and would support financial stability planning. Information from trade repositories can be used by regulators to assess risks on the books of their regulated entities, and could enable the market as a whole to identify aggregated risks for specific asset classes. This is in line with the G20 communiqué, which requires the registration of all OTC derivative trades in a trade repository.

7.4 We welcome the industry's efforts to establish and use trade repositories for CDS, interest rate derivatives and equity derivatives. We are encouraged by the industry's commitment targets for trade repository usage and acknowledge the progress which has already been made.[10] We also welcome discussions regarding the establishment of trade repositories for other asset classes.

10 http://www.newyorkfed.org/newsevents/news/markets/2009/060209letter.pdf

7.5 However, mandating the creation of data repositories for smaller market segments could be disproportionately costly. A cost-benefit analysis should determine the need for trade repositories for these market segments.

7.6 We are also conscious that the use of more than one trade repository for any asset class would result in data fragmentation. The ways of aggregating data from a variety of sources, and the costs, need to be carefully considered in order to minimise the resources expended by regulators. A single trade repository per asset class would avoid this problem but may create monopolistic risks that would need to be managed.

7.7 We support the Commission's position that European regulators must have access to relevant global information. But we do not think that this should mean that specific repositories need to be set up in Europe, if there are adequate repositories already elsewhere. We support location-neutral policies with regards to the establishment of such central data repositories providing they are supported by internationally agreed information sharing arrangements.

Regulatory oversight of trade repositories

7.8 In light of the central role such repositories will play in OTC derivative markets, we support the view that these infrastructures should be subject to regulatory requirements. However, we do not consider it appropriate for the European Securities and Markets Authority (ESMA) to have authorisation and supervisory powers for trade repositories given the global context of trade repositories. In particular we would note that EU Finance Ministers agreed at Ecofin on 2 December 2009 that credit rating agencies should be the only entities subject to pan-EU supervision.

7.9 Whilst trade repositories will require some regulatory framework, in our view this should be reasonably high-level in approach, with provisions relating to areas including the legal basis, operational resilience, access criteria and transparency. A pan-European regulator is not necessarily needed to deliver this. In this context both the CPSS-IOSCO Working Group and CESR have established workstreams aimed at defining a broad set of requirements for trade data repositories. We are engaged in these efforts and are supportive of this work. It is anticipated that the work in the separate forums will be finalised in the first half of 2010. We would highlight the need to avoid duplication of these efforts.

7.10 Furthermore, we would highlight the new supervisory model being developed under the ORF for DTCC, the trade repository for CDS, whereby home state regulation is supplemented by a network of supervisors to ensure the information needs of global regulators are met. Further consideration should be given to how this might apply to other trade repositories.

7.11 We need a framework which supports the sharing of relevant information between the appropriate authorities to enable them to fulfil their regulatory responsibilities. The ORF is the best international forum to achieve this and work is already in hand to deliver this.

7.12 As indicated above European and international requirements will need to be sufficiently high-level to address common criteria for trade repositories, but

individual repository functions will be tailored to the specific asset class it records and reports and as such national supervisors may be required to tailor additional requirements to the repository in their jurisdiction.

7.13 In the UK, the FSA's Service Company regime provides the necessary flexibility to provide a regulatory umbrella for trade repositories in the UK. The regime applies basic requirements with regard to systems and controls, governance, financial requirements and record keeping. However, it also gives the flexibility to strengthen standards to accommodate international and entity specific requirements where appropriate such as access, transparency and reporting.

Data reporting requirements

7.14 The FSA is actively engaged in the work of the ORF to define data reporting arrangements for CCPs and trade repositories serving the OTC derivative markets. The ORF has made good progress in defining reporting templates for CDS data, and the FSA is currently leading a workstream to identify specific reporting requirements for interest rate derivatives. In due course, the ORF will also define reporting for equity derivative trades.

7.15 This reporting would be made available to relevant authorities depending on their regulatory remit. It should be noted that these arrangements are not designed to supersede authorities' existing information-seeking arrangements or powers, including where information is sought directly from infrastructure or market participants.

Challenges

7.16 The current focus of regulators is on the registration of trades which have not been cleared by a CCP but ultimately regulators will need to have access to the complete picture of activity of the entities which they supervise. This could be achieved in a number of ways. For example:

- by requiring firms to register CCP cleared trades directly with the trade repository;
- for the relevant CCPs to submit a data feed directly to the repository; and
- or for regulators to obtain the data for cleared trades from CCPs directly and then to aggregate the data themselves.

7.17 Further work on this issue is needed and appropriate consideration should be given to the cost associated with each option.

7.18 Regulators are closely working with the industry and through fora such as ISDA to identify any potential difficulties in reporting trade data. One particular issue already highlighted concerns the confidentiality of reporting to a third party service provider and the subsequent use of that data. A legal assessment is currently being undertaken to further understand these difficulties. Initial indications are that there will be many legal obstacles to overcome in order to facilitate the legal registration of trades from participants in all jurisdictions.

II) Transaction reporting to regulators

The issue

7.19 In Europe there are no harmonised requirements for transaction reporting of **all** OTC derivatives. This may hamper the ability of regulators to detect market abuse.

UK Approach

7.20 In the UK OTC securities derivatives, such as contracts for difference (CFDs) and CDS, where their underlying instruments are admitted to trading on a regulated or prescribed market, are subject to the FSA transaction reporting regime. This is because there is evidence that the use of derivative contracts can be used to manipulate the price or exploit inside information of the underlying securities which are within scope of our Market Abuse regime. We support the extension of transaction reports of OTC securities derivatives by Member States who do not currently collect this information as this will enable more effective market monitoring across Europe. Work is in hand through CESR to achieve this.

7.21 The FSA does not require transaction reporting for other OTC non-securities derivatives such as interest rates, commodities and foreign exchange.

Need for further analysis

7.22 Further work is needed to assess whether there is a significant risk of abuse occurring in OTC non-securities derivative markets and whether regulators require further information about these markets either from transaction reports or from a trade repository. In assessing any proposals for extending transaction reporting requirements the following criteria should be considered:

- The availability of evidence that a particular class may be susceptible to market abuse.
- The degree to which the participants in each sector are regulated. For example many market participants are not MiFID investment firms.
- The degree to which the sectors are influenced by non-EEA entities as this will affect how complete the data will be. We know there is a strong international dimension to commodity markets.
- The degree to which the sectors are influenced by asset types we can control.

III) Trade transparency to the market

The issue

7.23 OTC derivative markets are not subject to formal pre and post trade transparency requirements. As a result some market participants have better access to better information on prices and volumes which can lead to an unfair advantage in terms of the price formation process.

Proposed approach: post trade transparency

7.24 The UK Authorities are of the view that well calibrated post-trade transparency has an important role to play in the efficient functioning of markets and we support the Commission's proposals to draw up legislation in this area.

7.25 In the *Turner Review* and accompanying DP09/02[11] the FSA set out a proposed framework for calibrating post-trade transparency regimes. It is essential that any regime is structured so as minimise the scope for a negative impact on liquidity due to an unwillingness of market participants to trade. We recommend that the following factors are taken into consideration:

1. The market participants;
2. The degree of market liquidity;
3. The degree of product standardisation;
4. The level of post-trade transparency already available in the market; and
5. Existing market infrastructure.

Market participants

7.26 The need for transparency differs across markets and classes of market participants. Some OTC derivative markets have a higher degree of inter-dealer participants (such as CDS) who often have access to greater information on traded prices and volumes. Others are characterised by higher investor participation (such as interest rate and foreign exchange derivatives) who tend to have access to less information. Increasingly these latter types of participants are expressing the need for better access to greater information. To better inform our view the FSA will undertake work to gain a clear oversight of the range of participants per asset class in question.

Market liquidity

7.27 A certain degree of market liquidity is needed in order to absorb the possible impacts of introducing a post-trade transparency regime. We need to avoid a situation where in publishing information on traded prices and volumes, participants become reluctant to commit capital and in turn withdraw liquidity from the market.

11 http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf

Product standardisation

7.28 A significant proportion of the OTC derivative products markets are complex and bespoke which can often reduce the meaningfulness of information on traded prices and volumes. Enhanced transparency is useful when there is a sufficient degree of product standardisation so to enable meaningful price comparison. In the first instance regulatory intervention should focus on this area. Indeed the moves towards greater standardisation as outlined in Chapter 3 will support the usefulness of post-trade information. It is unclear what benefits additional post-trade transparency can deliver to markets where products are bespoke and, as such, often illiquid.

Information already available

7.29 Some OTC derivative markets currently have a higher degree of post-trade transparency already available to a wide range of market participants. In calibrating the future regime legislators and regulators should be aware of what information is already available so as not to duplicate efforts.

Existing infrastructure

7.30 Any post-trade transparency regime should be delivered in the most cost-effective way. We should therefore look to existing infrastructure, for example data vendors, CCPs, trade repositories, to see how these can facilitate the delivery of timely post-trade information to market participants.

7.31 Taking the above factors into consideration it is therefore likely that any post-trade transparency regime will vary on an asset class by asset class basis.

The need for a cost benefit analysis

7.32 Central to this work will be the need to undertake a comprehensive cost benefit analysis to ensure that the anticipated benefits are not offset by a negative impact on liquidity or overly burdensome administrative costs. The FSA has found the interrogation of relevant transaction reports (whilst not designed for this purpose) to be useful tool in better understanding the frequency and size of trading and how this varies per asset class. We would encourage the Commission to undertake similar analysis.

7.33 Given the structure of European derivative markets and how they differ to equity markets, careful consideration will need to be given to how such a regime is implemented and how to ensure data accuracy.

Trade repositories as a mechanism for trade transparency

7.34 As noted above, one of the roles of a trade repository is to increase transparency to the market. This is achieved by making public reports of aggregated live positions, transaction activity, aggregate open interest and settlement data. For this type of market reporting the information disclosed should be at an aggregate level in order to comply with existing confidentiality requirements and minimise any potentially detrimental impact on market liquidity. Although for other types of trade reporting more granular information is likely to be needed.

Summary of the public data reports[12]

7.35 An example of increasing public transparency has been achieved through the OTC Derivative Regulators Forum who has already drafted a set of reporting templates for CDS. These reports include:

- Data on all live positions as of a specified date.
- Weekly activity as of specified date for aggregate positions.
- Weekly transaction activity as of specified date.
- Aggregate open interest by currency.
- Aggregate settlement data by currency denomination.

7.36 The UK Authorities support this and a similar framework for interest rate derivative reporting is currently being developed.

Pre-trade transparency

7.37 There has been little work to date regarding the need and benefits of extending pre-trade transparency requirements to assets other than shares. Some market participants, including some non-financial firms, are of the view that they generally have good access to accurate pre-trade information. Many market participants are of the view that post-trade pricing information is a more valuable source of information. This is particularly the case for bespoke products. The added dimension of on OTC trading framework can provide a challenge for introducing pre-trade transparency requirements. Further work is therefore needed and we would encourage the Commission to undertake a thorough analysis of pre-trade transparency related issues before designing a legislative framework.

12 http://www.dtcc.com/products/derivserv/data/index.php link to public CDS reports available from DTCC

8 The role of organised trading platforms

The issue

8.1 The liquidity of financial markets was severely impaired during the crisis with heightened concerns over counterparty risk resulting in an unwillingness of some participants to trade. For many participants wishing to trade not only did they struggle to find a willing counterparty, there was also an absence of price transparency which hindered the price formation process and valuation of existing positions.

Possible solutions

8.2 Trading through organised trading platforms provides regulators with transparency of trading and market conduct, and can provide market participants with a centralised pool of liquidity – tradable through a transparent central orderbook under standardised terms and conditions and predominantly cleared through a CCP. So regulated trading venues might appear to be attractive solutions to opaque and complex trading on OTC markets.

8.3 However, 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.

8.4 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.

Proposed Approach

8.5 It is essential that the option to trade derivatives OTC remains, but that the risks identified in paragraph 8.1 are mitigated through the use of CCP clearing for clearing eligible products, enhanced risk management procedures for non cleared trades and a sensibly calibrated transparency regime. We will keep the progress of these initiatives under review to ensure regulatory objectives are being met. Once these requirements are in place market forces can be expected to naturally move greater trade flow through organised trading platforms. At this stage is unclear what additional benefits mandating trading of standardised derivatives on organised trading platforms will deliver and costs would likely be significant. We urge legislators to approach this regulatory tool with caution with due regard to the market impact it may have.

9 Position limits

The issue

9.1 In commodity markets the regulatory debate has been focused on two discrete issues:

i Combating market manipulation

ii Controlling or limiting price movements

9.2 The first issue is a regulatory objective of the UK Authorities, whereas the second issue is not as it falls outside the current remit of the FSA (as defined by legislation). As the debate has unfolded the two distinct issues have often not been separated. However it is important to retain clarity of distinction between the two issues and to be clear about whether or not the issues being discussed relate to a current regulatory objective.

Position limits as a regulatory tool

9.3 The UK Authorities are supportive of all policy measures that are intended to prevent manipulative behaviour in derivative markets, particularly around those that have an element of physical delivery such as commodities. In this regard we welcome the Commission's efforts to provide regulators with the appropriate tools to combat manipulation consistently within national jurisdictions.

9.4 However, we are of the view that the regulatory focus should be on preventing manipulation by every type of market participant rather than on particular types of market participant. We do not believe, nor have we seen evidence, that a blanket approach through specific position limits is necessarily the most effective way to monitor, detect and deter manipulative behaviour in derivative markets, whether they are on exchange or OTC.

9.5 In relation to controlling or limiting price movement, we have seen no evidence to suggest that one particular type of market participant has been solely responsible for systematically driving derivative market prices. As a result, we do not believe that limiting one class of market participant by imposing specific limits is a desirable or warranted response to the changing nature of derivative markets. Furthermore, there is no evidence to date which demonstrates that prices of commodities, or other

financial derivatives, can be effectively controlled through the mandatory operation of regulatory tools such as position limits. We therefore do not believe these measures would achieve the goal of solving the perceived problems.

9.6 Whilst not opposed to the principle of regulators having the option of formal position limit setting powers in relation to combating manipulation for OTC markets, we do have concerns about the possible consequences. It is essential that any policy measures be carefully and sensibly calibrated and consistently applied and we encourage the Commission to undertake a robust impact analysis on this issue.

Risks of manipulation arising from large positions

9.7 Given the nature and structure of derivative markets, a common concern of potentially abusive behaviour relates to market manipulation, and specifically that effected from the holding of, and abusing, a large position. Although this type of manipulation may occur at any time in the life of a contract, there is a particular risk where a derivative contract approaches expiry, and upon expiry, where that contract is settled by physically delivering an underlying product (most usually some form of commodity). Hence there is a need for regulators to be comfortable that during this most high risk part of the contract cycle, risks of manipulation are minimised.

9.8 There are two main regulatory methods for preventing manipulation arising from large positions. Firstly the use of position and accountability limits, or secondly a more encompassing set of regulatory tools with an emphasis on a broad position management approach. The UK regime adopts the latter approach. (See paragraphs 9.12 to 9.15).

Position limits

9.9 Position limits were originally imposed in exchange-traded commodity derivative markets as a tool for ensuring that large positions were not amassed as the expiry of a physically delivered contract approached. There are two principal aims of this approach. Firstly, limiting concentrated and dominant positions reduces the risk of a "market squeeze".[13] Secondly, limits assist in maintaining market confidence and integrity by preventing participants from incurring obligations to accept or deliver large quantities of physical commodities where they are not equipped to do so. These limits may be set by regulators or by the exchanges on which the contracts are traded, depending on the contract and the regulatory regime in question.

9.10 Given their origins in the commodity markets, a position limit regime must recognise the need for certain "commercial" traders to hold large positions at given points in a contract life, in order to allow effective hedging of underlying price risk. An exemption-based position limit regime therefore comes with potential execution issues that would need to be carefully managed. Such an approach may pose significant administrative and logistical burdens in ensuring equality of treatment amongst all participants. There is also a cost in setting, monitoring and enforcing against limits in order for them to remain effective and credible.

13 A market squeeze in a derivatives market may occur when market shorts are artificially inhibited from obtaining a physical commodity to meet delivery obligations as a result of a controlling interest in that underlying commodity, and are thereby forced to close out their positions at grossly inflated prices.

9.11 Position limits have historically not been employed in OTC markets because both the diverse nature of such markets and the majority of products traded – some of which are illiquid, bespoke, and physical in nature – are not conducive to such a framework. Given the complex, disparate and international nature of OTC markets we consider position limits to be unworkable on a market-wide basis.

A position management approach

9.12 The FSA's remit does not extend to regulating price levels, or to limiting activity of certain parts of the market, such as financial participants, solely due to the nature of their activity. In the UK, the overall aim in regulating derivative markets – both OTC and on-exchange – is to ensure that markets are fair and orderly, that investors are afforded suitable protections, and that market abuse by market participants is prevented as far as possible and, where it occurs, is detected and dealt with appropriately.

9.13 The UK regime does not require exchanges to impose position limits on their markets. Rather, in order to satisfy the requirement to operate markets which are fair and orderly at all times, all UK exchanges have incorporated broader position management powers into their rules.

9.14 Members of UK exchanges are required to abide by the position reporting requirements as set out in the rules of the exchange. These rules also give the exchanges authority to manage positions at any time throughout a contract's life cycle and to instruct a member to close or reduce a position with the exchange, if that is necessary, to secure fair and orderly markets. If the member does not comply, the exchange has the power to close the position unilaterally.

9.15 A position management approach such as the UK's takes account of contract liquidity as well as the scale and nature of participants involved at any given point in time; this is not necessarily the case with a position limit regime.

Commission proposals for combating manipulation

9.16 The Commission proposes to give regulators the possibility of introducing position limits to counter disproportionate price movements in European derivative contracts. Whilst the UK Authorities are not opposed to regulators having the *option* to set limits as one tool to help combat market manipulation, the adoption of such a policy would be a departure from the approach taken across all financial derivative markets in the UK and is not necessarily the best means of combating manipulation. In adopting such a policy the UK Authorities are concerned that there would be an expectation for regulators to use position limits and we do not think this is conducive to achieving the most effective regulatory outcome.

9.17 The UK Authorities do not consider that precluding, or limiting, financial participants as a group in UK commodity, or broader derivative, markets would necessarily reduce the potential for manipulation. Moving away from a regime which is flexible and established, to a different and more rigid system would imply there is an identifiable problem with the current regime. We have seen no evidence of this.

9.18 Furthermore, as we emphasise above, it would be hard to apply such limits to the OTC market with any degree of rigour or with certainty that the objective was being achieved because of the vast and disparate nature of the market. We are keen to ensure that any policy is carefully structured so that is does not inhibit the critical role OTC markets play and does not result in trading activity migrating to less transparent regulatory regimes.

Commission proposals for combating speculation

9.19 The second limb of the Commission's proposal is to give regulators the possibility of setting position limits to counter concentrations of speculative positions. Such an approach would go beyond the existing legislative remit in the UK and more importantly we have not seen evidence which supports such an approach. The UK regime applies its position management tools to all participants, without a specific emphasis on those that do not have a desire to hedge physical positions, or take physical delivery. We do not consider activity by financial participants to be de facto manipulative. We do not therefore consider that there should necessarily be a distinction made between "large speculative" and "large non-speculative" positions for the purposes of combating manipulation – the focus should be on combating "large positions that lead to manipulation" irrespective of whether they are held by financial participants or not.

Non-Commercial Participants

9.20 Over the last two years, certain commentators and market observers have linked the growth in financial, or "speculative", participation in commodity markets with recent significant price movements, particularly in oil. We recognise that this type of investor has impacted the nature of commodities markets as a whole, for example, as a result of different methods of trading and increased volumes.

9.21 However, the majority of academic studies and evidence do not support the proposition that prices have been systematically driven by this increased inflow of financial interest. Indeed the majority of commentators have concluded that commodity price movements cannot be solely attributed to the activities of any one class of investor and are principally attributable to market wide factors. We agree with these conclusions.

Proposals for combating price movements

9.22 The FSA's regulatory aim (as defined by legislation) is on maintaining fair and orderly markets, not limiting price movements or volatility. In any event, we do not believe a case has been made which demonstrates that prices of commodities, or other financial derivatives, can be effectively controlled through the mandatory operation of regulatory tools such as position limits, whether on exchange or OTC. Analysis of market data where position limits are already in use suggests that this has not shown a reduction in volatility or absolute price movements compared to contracts where they are not.

9.23 We also consider that limiting financial participation more generally would hamper market efficiency. To use oil markets as an example, increased participation has brought significant benefits, such as greater depth and liquidity. In particular we

believe greater liquidity should be encouraged in this market, particularly if it facilitates the hedging of the longer maturities that are more closely aligned to the petroleum investment and production cycle. This in turn would enable producers to invest in long term projects with greater certainty, knowing today what prices they can sell at once the production comes on-stream.

9.24 To restrict participation to producers and end-users, and to exclude, or even limit, financial players would, in the view of the UK Authorities, be unlikely to have a controlling effect on market prices, and potentially be detrimental to efficient markets and the price formation process in general.

Proposed Approach

9.25 The UK Authorities would urge caution in the application of any specific position limit power, and the expectation that these regulatory tools might achieve the objective of reduced price volatility, or manipulation, as there appears to be no conclusive evidence that this may be the case. We also call on legislators to give careful consideration to the broader possible consequences of introducing a position limits regime. In our view a broader position management approach which does not focus on one type of participant is the most effective approach to ensuring market integrity in derivative markets.

10 Conclusions

10.1 Policymakers and legislators on both sides of the Atlantic are currently deliberating a comprehensive set of proposals which are designed to support more robust, efficient and transparent derivative markets. It is important that the overall package of policy measures are deigned so as to most effectively address systemic risk and transparency issues.

10.2 As outlined in this paper the UK Authorities support drives towards greater standardisation but note that the degree of standardisation is not the only criterion to consider when determining whether a product should be cleared. Instead we strongly support the use of central clearing for clearing eligible derivatives through robustly managed clearing houses that meet a uniform set of high standards. These should be further supported by effective supervision by home state regulators. Trades which are not centrally cleared should be subject to robust bilateral collateralisation processes and/or the appropriate risk-proportionate capital charge.

10.3 We support the registration of all OTC derivative transactions in a trade repository with further transparency provided to the market through sensibly calibrated transparency requirements.

10.4 Once these proposals have achieved their intended outcome it is unclear at this stage what benefits forcing trade flow through organised trading platforms would deliver. We urge legislators on both sides of the Atlantic to approach this regulatory tool with caution as regulatory objectives can be achieved by other means. Indeed once current proposals are implemented and have had the opportunity to bed down we can expect market forces to move more trading activity through these types of trading venues.

10.5 As we have outlined the current broad position management approach adopted in the UK is effective in combating market manipulation and so we see no need to introduce position limits for this purpose. With regards to controlling or limiting price movement we have not seen evidence that a position limits regime is needed.

10.6 As highlighted throughout this paper there is a very significant amount of work underway within the international regulatory community and in partnership with the industry. It is essential that legislators do not pre-judge the outcome of these pieces of work; that careful consideration is given to this work when defining legislation; and that there is not an unnecessary duplication of efforts.

10.7 We are also encouraged by the Commission's commitment to undertake comprehensive impact assessment before publishing draft derivative reform legislation. We will look to help by making available UK market information for this work.

10.8 These work streams can be expected to evolve as regulatory engagement increases. In order to achieve the appropriate sequence of outcomes it is important that prioritisation is discussed and agreed amongst relevant stakeholders in order to ensure the most effective deployment of resources.

10.9 But whilst significant strides have been made within these fora more still needs to be done. We are encouraged by the commitment shown by the industry to support change so far and we ask that sufficient momentum and resourcing is maintained.

10.10 As further detail of the package for regulatory change emerges we look forward to working with our colleagues across the globe to ensure that an internationally consistent set of definitions and outcomes are achieved so as to maximise the impact of these historic reforms.

Glossary of terms used

CCP	Central counterparty
CESR	Committee of European Securities Regulators
CPSS-IOSCO	Committee on Payment and Settlement Systems – International Organisation of Securities Commissions
CSD	Central Securities Depository
ESCB-CESR	European system of central banks – Committee of European Securities Regulators
ESMA	European Securities and Markets Authority
G15	Group of 15 major derivative dealers: Bank of America-Merrill Lynch Barclays Capital BNP Paribas Citigroup Commerzbank AG Credit Suisse Deutsche Bank AG Goldman, Sachs & Co. HSBC Group JP Morgan Chase Morgan Stanley The Royal Bank of Scotland Group Société Générale UBS AG Wachovia Bank, N.A.
G20	The Group of Twenty Finance Ministers and Central Bank Governors (known as the G-20 and also the G20 or Group of Twenty) is a group of finance ministers and central bank governors from 20 economies: 19 countries, plus the European Union (EU)
ISDA	International Swaps and Derivatives Association

OMG	Operations Management Group
ORF	OTC Derivative Regulators Forum
RMMG	Risk Management and Modelling Sub-Group

Overview of international regulatory workstreams

Geographic Relevance	Forum	Workstream / Content	Detail
EU	**CESR**	Trade Repositories Consultation Paper – functions, location, legal framework	http://www.cesr.eu/data/document/09_837.pdf
		OTC instruments classifications consultation paper	http://www.cesr.eu/index.php?page=consultation_details&id=146
EU	**ESCB-CESR**	Implementation of Recommendations for CCPs and CSDs	http://www.cesr.eu/index.php?page=document_details&id=5775&from_id=56
EU	**European Commission**	OTC derivatives communication – initiatives aimed at reducing counterparty credit and operational risk, increase transparency in trading and through the use of repositories, improve market integrity.	http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20091020_563_en.pdf
	(with CESR input)	MiFID Review – scope to be decided	
International	**Basel RMMG – Risk Management & Modelling Group**	• Review of CCP exposures' risk weighting • Review of bilateral collateralisation	
International	**CPSS – IOSCO**	Review of Recommendations for CCPs clearing OTC derivatives	http://www.bis.org/press/p090720.htm
		Recommendations /Issues for consideration for Trade Repositories	
International	**IOSCO**	Commodity Futures Market Task Force	

Geographic Relevance	Forum	Workstream / Content	Detail
International	**OTC Derivatives Regulator Forum (ORF)**	Regulators Forum to discuss developments on OTC derivatives clearing initiatives and trade repositories. Five dedicated working groups have been set up: 1. Information needs for market regulators 2. Prioritisation of additional data reporting items 3. 'Business purpose' information 4. Data reporting formats, delivery mechanisms, aggregation 5. Data reporting for rates repository	http://www.newyorkfed.org/newsevents/news/markets/2009/ma090219.html
International	**OTC Derivatives Supervisors Group**	Monitoring CCP usage; Electronic processing; bilateral collateralisation practise; buy-side access	
International	**ISDA Industry Governance Committee (IIGC)**	Industry group working on commitments to supervisors for market practice and post trade activities. Below the IIGC are Steering Committees for – Each product class (CDS, Interest Rate Derivatives, Equity Derivatives) – Operational matters – Collateral management matters Below these are Implementation and Working Groups.	www.isda.org/

Annex 3

Overview of CCP clearing for OTC derivative markets

Credit default swaps

There are currently three clearing houses that are actively clearing CDS products, ICE Trust, ICE Clear Europe and Eurex. It is expected that and CME will launch their service by the end of the year and LCH.Clearnet SA in January 2010.

Across the three existing clearing houses, the products eligible to be cleared by these entities are currently the liquid indices – namely High Yield, HiVol and Crossover for both CDX and ITraxx – and a handful of single names. We expect to see this product set widen in the near future to include the single names contracts for the constituents of the indices already being cleared. The G15 banks have committed to clear 80% of these products from October 2009. Good progress is being made against these targets but momentum needs to be maintained.. Regulators will actively monitor progress against these targets and take steps to address any failures. The clearing target level will apply automatically as the product set expands.

However, this will still leave a large proportion of both the index (tranched and untranched) and single name population which are at this stage unclearable. There are challenges to expanding the products available to be cleared as liquidity and price transparency are important factors in being able to build a robust risk management process necessary for a clearing house. There may also be further challenges ahead in standardising the products, such as tranched indices, so as to reduce the operational risk to clearing houses.

Other asset classes

Whilst much of the regulatory focus to date has been in supporting CCP clearing for CDS there are already clearing houses established for the clearing of other asset classes. In addition there are proposal either to expand the current scope of coverage to other product lines or indeed to establish new clearing houses for asset classes not currently covered by CCP clearing. The UK Authorities support the progress being made in this area.

LCH.Clearnet Ltd operates a clearing service for interest rate swaps with indications that it clears over 60% of the global interest rate swaps market. As at the end of

September 2009, LCH.Clearnet Ltd held open interest of over 3200 trillion in SwapClear contracts. LCH.Clearnet Ltd also provides clearing services for OTC commodity derivates contracts. Although these commodity contracts have won some market support their volumes are significantly lower than for LCH's swaps products, reflecting the differing nature of the underlying market.

In addition to the OTC CDS products noted above, ICE Clear Europe clears OTC energy products traded through the global OTC trading venue operated by ICE group. These products include oil, gas and electricity contracts.

CME provides a clearing service for over 700 commodity contracts through its ClearPort OTC clearing service. These contracts include metals, energy, and agricultural products and have average daily volumes of over 700,000 contracts. CME has also applied for recognition from the FSA and intends to launch a European clearing house within the next six months. They plan to make OTC CDS products available through this clearing house.

CME plans to accept FX contracts for clearing through ClearPort by the end of 2009. Other clearing houses have expressed interest in also providing clearing services for OTC FX products, but none has announced firm plans to launch such a clearing service. This lack of progression towards service provision is likely to be largely a result of a perceived lack of appetite for central counterparty services amongst FX market participants, rather than any specific operational or legal challenges presented by the FX market.

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