



**DRAFT REGULATORY TECHNICAL STANDARDS ON  
RISK MITIGATION TECHNIQUES FOR OTC DERIVATIVES NOT CLEARED BY A CCP  
UNDER THE REGULATION ON OTC DERIVATIVES, CCPs AND TRADE REPOSITORIES**

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**Discussion Paper from the Joint Committee of the European Supervisory Authorities**

**A response by the Futures and Options Association**

**April 2012**

## DRAFT REGULATORY TECHNICAL STANDARDS ON RISK MITIGATION TECHNIQUES FOR OTC DERIVATIVES NOT CLEARED BY A CCP UNDER THE REGULATION ON OTC DERIVATIVES, CCPs AND TRADE REPOSITORIES

- 1.1 This response is submitted on behalf of the Futures and Options Association (“the FOA”), which is the principal European industry association for 160 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1).
- 1.2 The FOA has confined its response to general points of principal rather than respond to the questions in detail, insofar as the FOA believes that the risk mitigation of OTC derivatives is primarily a matter for ISDA and its membership.
- 1.3 In general terms, the FOA represents the listed derivative markets, and we very much support the current drive to make the OTC markets safer, bearing in mind their interconnected nature, their size and the fact that, in the EU, they were under-regulated before the crisis and, in the US, not regulated at all. We also note that part of the programme of reducing the risk of these markets includes introducing some of the benefits of trading in the listed derivatives markets to OTC markets, eg closer supervision of dealings, enhanced and improved post-trade processing, new and better risk-based prudential requirements and, where eligible, CCP clearing and, where the contracts are sufficiently developed and liquid, multilateral execution.

On the other hand, it is equally important that ESMA bears in mind that the OTC markets – which are complementary markets to the listed derivatives markets – are not unduly constrained by ESMA’s technical standards to the point where they are not able to fulfil their diversified role in terms of:

- (a) acting as an economically viable “birthpool” for introducing new contracts insofar as, once a market has developed over-the-counter, it is easier for the exchanges to then develop a standardised contract that is suitable for multilateral execution (NB. By way of contrast, exchanges have launched many new contracts which were eligible for CCP clearing, but inappropriate and insufficiently developed to be capable of multilateral execution and which then failed);
- (b) facilitating dealings in small specialist markets, where participation is too small for the purpose of being traded multilaterally on an economically viable basis;
- (c) enabling fund managers, corporate treasurers and other institutional end-users to enter into tailored bilateral risk management transactions to address their unique and sometimes complex underlying business risks.

In putting this forward, the FOA would emphasise that this is not intended to suggest that exposures in OTC markets should not be (a) properly capitalised and, of course, it is generally recognised that they were under-regulated and under-capitalised in the past; or (b) adequately collateralised.

- 1.4 The FOA supports the proposition in the DP on page 6 that “*CCPs are the Regulation’s primary tool for mitigating the contagion – or, systemic – risk posed by*

*one counterparty's default to the solvency of others within the derivatives market*", but would make the general practical observation that, if neither the counterparty nor the exposure entered into by it pose any substantial systemic risk, then there is less compulsion to force the relevant transaction to be cleared by the CCP.

This, in turn, means that, while it is correct as stated on page 6, that *"it is essential that counterparties apply robust risk mitigation techniques to their bilateral relationships to mitigate the counterparty credit risk"*, the FOA would urge the avoidance of the imposition of risk mitigation techniques to such dealings on the basis that one of ESMA's objectives is to mitigate *"potential systemic risk"* if, in fact, as previously stated, there is none.

In other words, we would urge the ESAs to avoid imposing requirements on the assumption that there is a systemic risk applying to all non-CCP cleared transactions when that may simply not be the case.

- 1.5 In this context, the FOA notes a key policy objective behind setting appropriate capital and collateral requirements for bilaterally-traded non-CCP cleared exposures is to avoid *"disincentivising central clearing or creating incentives to use less standardised derivatives with the objective of circumventing the clearing obligation"*. The FOA does not believe that this is an appropriate policy objective for risk-based prudential regulation. The FOA recognises that new risk-based requirements will result in increased costs for OTC dealings, but it continues to be important that they are accurately risk-based, particularly bearing in mind the possible consequences for small OTC markets and non-systemically important bilaterally-traded contracts (see para 1.7 below).
- 1.6 The FOA very much supports the observation by the ESAs in their DP that it is *"crucial to align international standards"*. It is assumed therefore that the final proposals will be very much in line with the work currently being undertaken by a number of international standard setters in determining margining standards for non-centrally cleared derivatives.
- 1.7 The FOA is mindful of the increased "pass-on" costs that will be faced by different types of end-users and is concerned, particularly, that the purpose of affording non-financial end-users with an exemption from CCP clearing their risk management transactions, could be undermined if the revised capital treatment of non-CCP cleared transactions becomes prohibitive.
- 1.8 With regard to the Initial Margin requirement, the FOA would repeat the observations made on para 1.5 above and would urge therefore:
  - (a) that the ESAs undertake, as promised, a comprehensive analysis of the potential costs and benefits of the proposed standards and to ensure that they are fully taken into account in finalising them;
  - (b) that counterparties are enabled to determine on a contract-by-contract basis what would be the most efficient and practical methodology for mitigating the risk of a

particular non-CCP cleared contract (which could include the imposition of an initial margin requirement), particularly in relation to contracts that are not deemed to be of systemic importance;

(c) that, where counterparties have several different types of exposures that have to be risk managed, they can net and offset positions across correlated exposures;

(d) the ESAs to consult fully on the practical implications and the time necessary to meet the new requirements, bearing in mind the additional tiers of capital and collateral that will have to be provided and that all the technical standards and thresholds will need to be finalised before firms should be obliged to start the process of putting the new requirements in place.

- 1.9 It is important to bear in mind that many financial and non-financial end-users do not have the kind of assets that would be acceptable if a very narrow definition of eligible collateral were to be adopted. Further, the costs of transforming that collateral to make it acceptable is likely to be extremely expensive, particularly if, as is anticipated, the current tensions in supply and demand of highly liquid collateral generate the expected “collateral crunch”. Absent a practical approach to this issue, this could generate an end-user “freeze” on market dealings, particularly by small- and medium-sized enterprises.
- 1.10 Initial margin is a primary requirement for a CCP to meet the “survivor pays” approach in the event of a default, but that is not the case with bilateral transactions, which do not, in themselves, generate the kind of mutualised support and inter-reliance that applies in the case of a CCP.
- 1.11 In view of the often highly-tailored nature of those bilaterally-executed transactions which do not lend themselves to being cleared by a CCP, it is important that the ESAs resist developing an unduly prescriptive and standardised approach to covering risks that are not standardised, i.e. the FOA would urge the ESAs to adopt an exacting criteria-based approach, reflecting the kind of factors that will have to be taken into account in establishing the appropriate risk-mitigation regime applicable to a particular contract and then to monitor how that approach has been adopted across comparable groups of transactions. It is noteworthy that, in large part, ESMA has adopted a criteria-driven approach in its own DP in preference to prescriptive lists and detailed formulae.
- 1.12 As it was put in the IMF Global Financial Stability Report “Meeting New Challenges to Stability and Building a Safer System” (April 2010), “*many end-users continue to prefer OTC bilateral arrangements in order to meet their specific hedging requirements and hence have a desire for customised contracts*” (Chapter 3, page 10). In line with this recognition of the preference of end-users, the Commission in its Communication “Ensuring efficient, safe and sound derivatives markets: Future policy actions” (COM 2009 563/4) recognised the importance of risk management and emphasised that it “*does not want to limit the economic terms of derivatives contracts, neither to prohibit the use of customised contracts nor to make them excessively costly for non-financial institutions*”.

**LIST OF FOA MEMBERS**

**FINANCIAL INSTITUTIONS**

ABN AMRO Clearing Bank N.V.  
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Altura Markets S.A./S.V  
AMT Futures Limited  
Jefferies Bache Limited  
Banco Santander  
Bank of America Merrill Lynch  
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