



EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROPEAN COMMISSION'S PUBLIC CONSULTATION ON DERIVATIVES AND MARKET INFRASTRUCTURES

EUROSYSTEM CONTRIBUTION

I INTRODUCTION

With a view to meeting the G20's commitment to promote resilience and transparency in the OTC derivatives markets, the Eurosystem supports regulation in the field to provide for central counterparty (CCP) clearing for derivatives contracts (i.e. those to be defined as eligible), for the reporting of OTC derivatives contracts to trade repositories (TRs) and for the establishment of the requirements that CCPs and TRs must fulfil to ensure their safety and soundness. It very much welcomes the general approach that the Commission is proposing and agrees, in particular, that financial market infrastructures such as CCPs and TRs are effective tools for controlling and mitigating risks in the financial system.

As the legislative proposal aims at promoting financial stability in the OTC derivatives markets and as central banks play an important role in protecting financial stability, the adequate involvement of central banks in the various fields as specified below needs to be ensured.

This document presents the Eurosystem's views on the Commission's public consultation on derivatives and market infrastructures dated 14 June 2010. It consists of two parts. First, it provides a few general observations on aspects that the Eurosystem considers to be particularly important from a central bank perspective. Second, it provides short answers to the individual questions raised in the consultation document.

2 GENERAL OBSERVATIONS

2.1 THE ROLE OF INTERNATIONAL STANDARDS: THE WORK OF CPSS-IOSCO

In addition to the legislative initiatives in Europe and elsewhere, regulatory work is going on in parallel following the G20 mandate to promote the use and soundness of central clearing and to ensure the consistency of regulatory rules. In particular, a joint group of central banks and securities regulators comprising members of the Committee of Payments and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) are currently reviewing the existing regulatory standards for financial market infrastructures, including central counterparties.

To ensure the consistency of regulations at global level, the Eurosystem strongly believes that it will be necessary for any legislative provisions on financial market infrastructures to be consistent with the ongoing work of CPSS-IOSCO. To this end, EU acts should usefully make reference to and take into account the standards developed by CPSS-IOSCO in this field. From a legal perspective, this could be achieved by adopting a regulation which focuses on high-level principles and assigns the responsibility of developing technical standards to an appropriate Union body for the endorsement of the Commission. In doing so, the regulation should invite the approved body to cooperate closely with the European System of Central Banks (ESCB) where appropriate

and make use of any relevant international standards. A similar approach is foreseen under the US draft “Act to provide for financial regulatory reform, to protect consumers and investors, to enhance Federal understanding of insurance issues, to regulate the over-the-counter derivatives markets, and for other purposes”, which allows the relevant authorities to make use of international standards for their regulatory activities. It is important to ensure that this is also possible in the European Union.

This approach would also enable regulation to have the appropriate degree of granularity and technical detail. On the one hand, it is essential not to refer to high-level principles only, but also to specify to the greatest extent possible all definitions, requirements and standards in the legislation to ensure legal certainty and a strict and uniform application of provisions. On the other hand, regulation should avoid an excessive level of granularity that might be in contradiction with the standards developed by CPSS-IOSCO or prevent CCPs from adapting to developments in financial markets and associated risks. Technical standards can be changed more easily than legislation to take into account such developments.

In this context, the Eurosystem would like to underline its competence pursuant to Article 22 of the Statute of the European System of central banks and the European Central Bank. Any regulation of an EU body, not only at level 1 but also at level 2, should be subject to consultation of the ECB according to the Treaties.

2.2 THE ROLE OF CENTRAL BANKS

The Treaty on the Functioning of the European Union and the Statute of the European System of Central Banks and of the European Central Bank contain a number of provisions relating to “clearing and payment systems” and assign oversight responsibilities to the Eurosystem. To this end, owing to its responsibilities for

preserving systemic stability, it is imperative that a central bank is able to raise possible concerns regarding the handling of its currency by a CCP. It should therefore be given an adequate role in the regulatory and oversight framework, the setting of standards and the authorisation process for CCPs. Moreover, as a central bank may decide to offer a range of services (deposit, settlement and liquidity) to CCPs, it will have to be reassured that any central counterparty it offers services to is safe and sound.

While any secondary Union act cannot regulate on central bank competences, it will need to reflect the statutory powers of central banks. A regulation on OTC derivatives and market infrastructures could therefore not regulate on central banks’ competencies in this area, but could and should reflect such competencies and impose obligations to cooperate with central banks on any relevant authority that may be empowered to regulate/supervise post-trading infrastructures and/or elaborate on Union acts applicable to such infrastructures. A regulation would need to ensure proper reference to the powers of the ESCB in the recitals of the proposed regulations and the imposition of obligations on the authorities to cooperate closely with the central banks.

For this reason, while supporting the need for consistency in the development and application of rules for the oversight and regulatory process, the Eurosystem considers that the role to ensure consistency should not be assigned exclusively to the securities regulators, but should be complemented and balanced by the adequate involvement of the central banks. In fact, in recognition of the importance of both regulation and oversight, the CPSS-IOSCO’s recommendations share competences for regulation and oversight between securities commissions and central banks on an equal footing. Union acts should adopt the same logic. In general, close coordination between securities regulators, banking supervisors and central banks as overseers is needed to avoid double regulation and loopholes.

More specifically, the Eurosystem considers that the role of the central banks should be explicitly reflected and spelled out in the following regards: First, the determination of “eligibility for the clearing obligation” should not be carried out by the European Securities and Markets Authority alone, but in cooperation with the ESCB. Second, as explained in detail above, the setting of any technical standards and requirements for CCPs and TRs by a Union body should be conducted in cooperation with the ESCB. Third, central banks should be involved both in the authorisation and ongoing supervision and oversight of CCPs. Fourth, in view of relations with third countries, the Eurosystem considers that the decision to recognise third country CCPs should not be taken by the Commission alone, but in close cooperation with the central banks in order to ensure that any central bank concerns and policies regarding, for instance, liquidity and risk management, oversight and location are adequately reflected. Finally, an adequate participation of central banks of the Eurosystem should be ensured in the new EU bodies, as well as an adequate cooperation mechanism, particularly between the Eurosystem and the future ESMA.

2.3 THE INDEPENDENCE OF CENTRAL BANKS IN PROVIDING FACILITIES TO INFRASTRUCTURES

Central banks may offer CCPs a range of facilities, possibly including credit, deposit and settlement services, depending on their statutory tasks and responsibilities. The Eurosystem recognises that central banks’ facilities may be an important tool for market infrastructures in view of their liquidity and risk management. For example, it might be useful for a CCP to make use of a central bank’s deposit facility in times of uncertainty or when it holds unexpected excessive cash balances. Similarly, it will be helpful for a CCP to hold a significant portion of its collateral as central bank eligible assets. Moreover, the Eurosystem considers central bank money as the safest asset for cash

settlement purposes. However, central bank facilities are not designed *per se* to meet the business needs of market infrastructures, and it remains for each central bank to determine for itself which facilities it wishes to offer to CCPs and other market infrastructures.

The Commission’s consultation document foresees an obligation for a CCP to deposit the liquidity that it has collected from its participants and to ensure its normal functioning with the central bank. The Eurosystem does not support such an obligation, as it may have an impact on the availability of liquidity and therefore interfere with the implementation of monetary policy.

The Eurosystem welcomes that the Commission’s consultation document encourages the use of central bank money for the settlement of cash transactions and expresses a general preference for it over other settlement arrangements by specifying that settlement in central bank money should always be used where practical and available.

Finally, the Eurosystem welcomes the fact that the Commission’s consultation document does not contain any suggestions to regulate access to central bank credit. More than for other facilities, the decision to provide routine or emergency credit is a prerogative of a central bank and is linked directly to monetary policy. Nevertheless, the Eurosystem sees a need for the future regulation to specify that the CCP must be able to ensure smooth and timely settlement of its obligations and to contain liquidity pressure also in scenarios in which it cannot easily liquidate any collateral that it has.

3 ANSWERS TO SPECIFIC QUESTIONS

Question:

What are stakeholders’ views on the clearing obligation, the process to determine the eligibility of OTC derivative contracts for mandatory clearing, and its application?

Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

Answer:

The Eurosystem supports the introduction of a general clearing obligation for OTC derivatives as a way to promote the central clearing of OTC derivatives transactions. However, the introduction and application of a general clearing obligation should be handled with sufficient caution in a way that does not expose the central counterparty to a sudden and abrupt increase in volumes to clear, which it cannot adequately handle with its existing capacities. Similarly, the central counterparty should not be obliged to accept trades from participants that it does not consider appropriate from a risk management point of view.

Moreover and importantly, in view of their statutory roles and responsibilities for financial stability, the central banks need to be closely associated with ESMA on an equal footing in the process of determining the eligibility for the clearing obligation.

Finally, while recognising the importance of access from trading venues to CCPs for the implementation of a general clearing obligation, the Eurosystem wishes to point out that such multiple accesses imply a number of operational complexities that a CCP should be prepared and able to handle.

Question:
Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?

Answer:

While the Eurosystem recognises the hedging needs of corporate end-users, it considers that any loopholes that may undermine the effective implementation of a general clearing obligation should be avoided. In general, any exemptions that may be envisaged for non-financial firms

should be conservative. Against this background, the Eurosystem welcomes the proposed approach of applying the general clearing obligation also to non-financial counterparties that take positions above a threshold of systemic relevance. The definition of threshold should be developed in cooperation with the ESCB.

Question:
Do stakeholders share the principle and requirements set out above on the risk mitigation techniques for bilateral OTC derivative contracts?

Answer:

The Eurosystem considers that a general clearing obligation needs to be complemented by adequate regulation for bilaterally cleared trades. There should be clear incentives for trades to be centrally cleared via CCPs, particularly through higher capital requirements for bilaterally cleared trades as foreseen in the consultative document “Strengthening the resilience of the banking sector” of December 2009 by the Basel Committee on Banking Supervision (“Basel III”) and as scheduled in forthcoming changes to the Capital Requirements Directive (“CRD IV”).

While, in principle, bilaterally cleared trades should be subject to bank risk management practices that are as closely as possible modelled to those of licensed CCPs, full consistency may be neither fully achievable nor desirable in all cases. The CRD and the Basel II capital framework already provide incentives for banks to collateralise credit, but the provision of such collateral is generally not a precondition for granting credit or for a certain type of credit. Banks should therefore continue to be able to consider the creditworthiness of their counterparties. They should also be able to take a proportionate approach with smaller, non-financial clients that may not have sufficient liquidity or credit facilities in place to make daily variation payments. It is important that the access of these clients to the derivatives market is not impeded by market regulation.

Questions:

Do stakeholders share the general approach set out above on organisational requirements for CCPs? In particular, comments are sought on the role and function of the Risk Committee; whether the governance arrangements and the specific requirements are sufficient to prevent and manage potential conflicts of interest, stringent outsourcing requirements, and participation and transparency requirements?

Do stakeholders consider that possible conflicts of interests would justify specific rules on the ownership of CCPs? If so, which kind of rules?

Answer:

The Eurosystem agrees that CCPs should be subject to stringent transparency, outsourcing, participation and governance requirements. Moreover, the Eurosystem is of the view that the requirements on outsourcing should be addressed to CCPs rather than to authorities.

Questions:

Do stakeholders share the approach set out above on segregation and portability?

Answer:

A general clearing obligation will lead to the expansion of central clearing services to new participants and markets that would not otherwise have been subject to central clearing. As a result, participants in OTC derivatives central counterparties will be less homogeneous, with greater participation by smaller firms – especially buy-side firms and non-domestic institutions – either as direct clearing participants or clients. These structural changes may make it necessary for central counterparties to adapt their service offerings, business models, risk management and governance arrangements in several ways. The need to enhance protection of smaller firms should also be reflected from a regulatory perspective. To this end, the Eurosystem supports requirements aimed at facilitating the segregation of clients' assets, positions and margins.

Questions:

Do stakeholders share the general approach set out above on prudential requirements for CCPs? In particular, what should be the adequate level of initial capital? Are exposures of CCPs appropriately measured and managed? Should the default fund be mandatory and what risks should it cover? Should the rank of the different lines of defence of a CCP be specified? Will the collateral requirements and investment policy ensure that CCPs will not be exposed to external risks? Will the provisions ensure the correct management of a default situation? Are the provisions above sufficient to ensure access to central bank liquidity without compromising central banks' independence?

Answer:

The Eurosystem considers that CCPs should be subject to stringent risk control standards.

As regards the appropriate level of initial capital, the Eurosystem take the view that any regulation on capital requirements should be clear in three regards. First, the regulation should usefully distinguish between capital requirements needed at the point in time when the CCP asks for authorisation and the capital that is required on an ongoing basis. In determining such capital requirements, a range of factors needs to be taken into account to ensure that the capital is sufficient both in terms of amount and liquid composition. Ongoing capital requirements should have a dynamic element in place that allows covering the (changing) business risks of the CCP's ongoing activities.

Second, CCPs holding a banking licence should not face double capital requirements, but those with which they already comply should be taken into account. While the approach chosen to specify capital requirements for CCPs should, in principle, be consistent with the approach taken by the CRD in relation to operational risk, it should not restrict the scope and coverage of any more specific capital requirement in relation to the full range of business risks faced by CCPs and any arrangements for restructuring

or winding down their activities in an orderly way. As much as for other organisation and risk management aspects, reference to any CPSS-IOSCO standards on capital requirements will be helpful to ensure consistency at global level.

Third, any capital required to withstand losses stemming from business risks that are not related to a participant's default should be clearly separated from capital that the CCP might use to cover losses resulting from a participant's default. It would be helpful if a regulatory body, in cooperation with the ESCB, developed technical standards to further specify the high-level principles that the regulation contains on capital requirements, again making use of the CPSS-IOSCO standards in this field.

Finally, as regards the provision of central bank facilities, the Eurosystem would like to reiterate its position, as explained in detail above, as a general observation that any regulation must fully respect the independence of central banks. A central bank's facilities may be an important tool for market infrastructures in view of their liquidity and risk management. However, these facilities are not designed *per se* to meet the business needs of market infrastructures, and it remains for each central bank to determine for itself which facilities it wishes to offer to CCPs and other market infrastructures.

Questions:

Do stakeholders share the general approach set out above on the recognition of third country CCPs? Are the suggested criteria sufficient? Do stakeholders consider that additional criteria should be considered?

Do stakeholders agree with the extension of the clearing obligation to contracts cleared by third country CCPs to ensure global consistency?

Answer:

The Eurosystem considers that the decision to recognise third country CCPs should not be taken by the Commission alone, but in

close cooperation with the central banks in order to ensure that any central bank concerns and policies regarding, for instance, liquidity and risk management, oversight and location are adequately reflected. The Eurosystem has repeatedly expressed the view that CCPs providing services for euro-denominated products should be located in the euro area which would allow the Eurosystem to provide liquidity in euro if and when needed.

Question:

Stakeholders' views are welcomed on the general approach set out above on interoperability and the principles and requirements on managing risks and approval.

Answer:

While the Eurosystem recognises the objectives of interoperability to promote the freedom of choice, competition and the integration of the European financial market infrastructure in general, the Eurosystem would caution against establishing an absolute right of interoperability in view of the complexities at stake. Instead, the Eurosystem would propose an approach aimed at removing any barriers to the establishment of interoperability where needed.

The Eurosystem supports the adoption of stringent risk management requirements to address risks related to interoperability. In this regard, the Eurosystem would suggest not only considering the case of clearing participants' defaulting, but also that of a default of a CCP.

Questions:

What are stakeholders' preferred options on the reporting obligation and on how to ensure regulators' access to information with trade repositories? Please explain.

Answer:

If there is evidence or an indication that the unfettered access to such information might be restricted and cannot be fully guaranteed as the result of the location of the relevant TR, the Eurosystem would support a requirement for

TRs to be established in the European Union, especially if it turns out that other possible options (e.g. a memorandum of understanding between the Union and the third country in which the trade repository is located, or a requirement for the trade repository to establish a back-up site) do not allow European authorities to have full control over the processes conducted and the information stored by the TRs.

Questions:

Do stakeholders share the general approach set out above on the requirements for trade repositories? In particular, are the specific requirements on operational reliability, safeguarding and recording, and transparency and data availability sufficient to ensure the adequate function of trade repositories and the adequate protection of the data recorded?

Answer:

The Eurosystem welcomes the overall level of granularity of the requirements for TRs. As for the requirements for CCPs, the regulation should foresee the specification of further technical standards by an appropriate Union body in cooperation with the ESCB making use of the CPSS-IOSCO standards.

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