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Euroclear response to the public consultation

by the European Commission on the possible initiatives to enhance the resilience of OTC Derivatives Markets

Euroclear is pleased to be given the opportunity to offer its views on European Commission communication 'Ensuring efficient, safe and sound derivatives markets' and the related consultation on the possible initiatives to enhance the resilience of OTC Derivatives Markets. As a provider of securities settlement, custody and collateral management services[1], our comments relate to the general need to improve the infrastructure supporting OTC derivatives as well as to specific questions raised in the consultation document.

GENERAL COMMENTS

We welcome the European Commission Communication and consultation paper and fully support the focus on counterparty risk reduction in the derivatives markets which understandably leads to a generalised call for the development of CCP clearing solutions for OTC derivative transactions.

Within this context, Euroclear Bank has developed a service for the OTC derivative markets, DerivManager, the main feature of which is to allow parties to a derivatives transaction to collateralise their counterparty exposure in a dynamic and efficient way for all classes of OTC derivatives trades. We are of the view that this offers an interesting complement to existing and future CCP services for OTC derivatives and fits within the generalised call for a structural risk management solution in this market. DerivManager can be specifically appealing as a risk management solution for those OTC derivatives transactions that cannot (yet) be subject to CCP clearing, e.g. because the contracts are not (yet) sufficiently standardised. A short description of DerivManager's product features can be found in Annex.

SPECIFIC COMMENTS

Section 2 – Promoting further standardisation

Q3. Should non-standardised contracts face higher capital charges for operational risk?

Since capital requirements should be based on an objective risk assessment of the relevant instrument and counterparty, we are not convinced, prima facie, that non-CCP cleared derivatives should necessarily face higher capital requirements where they are subject to highly effective bilateral risk mitigation techniques.

[1] Euroclear group comprises the international central securities depository Euroclear Bank, based in Brussels, as well as the national central securities depositories (CSDs) Euroclear Belgium, Euroclear France, Euroclear Nederland, Euroclear UK & Ireland and NCSD, the CSD for Finland and Sweden.

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We broadly support the call for more standardisation of contractual parameters and actual contracts wherever possible, as this is a key contributing factor to achieving greater transparency in the markets and to allow the implementation of more streamlined and automatic solutions for clearing and processing of derivatives transactions through market infrastructures.

While standardisation is a sensible strategy to pursue the target of risk reduction through maximisation of the portion of CCP eligible business, it needs to be recognised that full standardisation of all derivatives contracts is unlikely (or even not achievable) and that innovation and developments in financial markets are likely to continue to result in non-standard tailored structures. While these may not be eligible for CCP-clearing, this does not imply that the related counterparty risks cannot be successfully mitigated through bilateral clearing arrangements or other mechanisms. The EC Communication recognises this and even promotes the strengthening of bilateral clearing arrangements.

Euroclear believes that existing market infrastructure solutions supporting bilateral clearing, such as our integrated DerivManager exposure/ tri-party collateral management solution, can achieve very similar risk mitigation effects in OTC markets as CCP clearing. They can provide for industry/market infrastructure solutions in terms of aligning positions and exposures bilaterally and agreeing on margin calls and integrates this with an efficient same-day collateral process to cover the full exposure.

Section 3 – Strengthening bilateral collateral management for non-CCP eligible OTC derivatives

Q5. How could the coverage of collateralised credit exposures be improved?
Q6. Are there markets where daily valuation, exchange of collateral and portfolio reconciliation cannot be the goal? Justify?
Q7. How frequently should multilateral netting be used?
Q8. Should bilateral collateral management be left to self-regulatory initiatives or does it need to be incentivised by appropriate legislative instruments?

It is common practice for banks to price their OTC derivatives, calculate their exposures, and then to call for (initial and/or variation) margin. The biggest hurdle to proper collaterisation of exposures arises from disputes over the value of the exposures and the subsequent collateral required to cover discrepancies. Exposure gaps between two parties can come from a dispute over the population of trades and/or the valuation of the portfolio. We acknowledge that progress has been made in reconciliation and dispute resolution but, in our view, OTC markets now need to be encouraged to agree on common rules and best practices on how to collateralise the exposure systematically on a daily basis for the undisputed and disputed amounts. Euroclear's DerivManager service suggests rules (which can be used for all OTC derivatives exposures) to be agreed between parties allowing automatic calculation (and common sign-off) of the margin call. Applying such techniques and procedures would resolve many disputes on collateral calls which too often still result in no collateral being applied.

When the margin call has been automatically calculated and agreed, collateral has to be moved immediately same day in order to ensure that the real exposure is

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effectively covered by collateral and that there is no collateral in transit between margin call date and collateral settlement date.

Bilateral collateral management arrangements have proven their efficiency for repos, stock lending and related financing instruments. The use of the same tools and process for collateral related to derivatives exposures provides the same efficiency. We believe that the Commission should take a balanced approach to risk mitigation, ensuring that existing bilateral risk mitigation techniques are actually recognised by regulators and are utilised by the market

Section 4 – Central data repositories

Q10. Which regulatory requirements should central data repositories be subject to?

Central data repositories are of great value to the efficiency of financial markets in general and OTC derivatives in particular. In considering the development of data repository solutions for OTC derivatives markets in Europe, the Commission should contemplate utilising infrastructures that already support the collection of data on the underlying instruments and leverage their existing technological capability, client reach and market access to develop scalable, fully secured and resilient solutions. As the Commission is aware, CSDs and ICSDs have long been regarded as safe data repositories for listed securities and debt instruments.

Given the fact that in excess of 60% of equity derivatives are on European equities, there is value in ensuring there is an appropriate European user-owned infrastructure supporting it. Euroclear has a long-standing experience in offering a secure and confidential depository environment for a broad range of instruments and it holds over EUR 18 trillion assets under custody. Through one of its subsidiaries, Xtrakter, owner of the TRAX trade matching system, Euroclear is also one of the leading regulatory reporting providers in Europe. Because of the nature of our activity and the large number of entities in the Euroclear group, we are regulated by a large number of securities supervisors and overseen by several national central banks. We therefore believe that the Euroclear group is well positioned to play a role and we have been actively responding to recent RFPs for data repositories issued by the ISDA.

Section 5 – Move clearing of standardised OTC derivatives to CCPs

Q14. Is the zero-risk weighting a sufficiently effective incentive for using CCPs across different market segments?

Q16. Should bilateral clearing of CCP-eligible CDS be penalised and, if so, to what extent? Is there a need to extend regulatory incentives to clear through a CCP to other derivatives products?

As stated above in our reply to Q3, the risks for non-standardised non-CCP eligible derivatives also needs to be mitigated. Provided that adequate risk mitigation mechanisms are applied to this segment of the derivatives business, we do not believe that any discriminatory measures should be implemented which would create an unlevel playing field.

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Q18. What is the minimum acceptable ratio of CCP cleared/eligible contracts? What is the maximum acceptable number of non-eligible contracts?

Whereas it is probably more in the remit of supervisors to set thresholds on the maximum acceptable number of non-eligible contracts (or reverse the minimum acceptable ratio of CCP cleared/eligible contracts), industry experience and market reality in OTC derivatives and other financial instruments nonetheless demonstrates that a significant part of the OTC derivatives is likely to remain less standardised or less suitable for CCP clearing (e.g. total return swaps). The main reason for this is their specific risk profile (too high model risk) or because the market for some of these instruments may be too small (making it difficult to price these instruments correctly). In addition, notwithstanding progressing standardisation of existing OTC derivatives contracts, new/innovative contracts will continue to emerge. Therefore, we are convinced that, while the importance of CCP cleared contracts will steadily increase as CCP markets gain experience and standardisation progresses, it remains important for supervisors to recognise that other solutions exist in the market that are complementary to CCP (i.e. DerivManager, triResolve, Markit PortRec). These solutions allow participants also to effectively manage their exposure/collateral for the not-CCP-cleared part of the portfolio.

Section 6 – Increase transparency of prices, transactions and positions

Q22. How should transaction reporting of OTC derivatives to competent authorities be envisaged? Should it be extended to all contracts or to certain categories? If so, which ones? Are there other means to ensure that the competent authorities receive the relevant information on OTC derivatives transactions?

Currently, reconciled transactions are reported daily to the regulators through the reconciliation engines for the inter-Fed 16 banks’ activity for all the trades under ISDA-CSA agreements. The future extension of the reconciliation beyond the FED signatories is on the industry’s roadmap.

In addition to this, the industry has defined a clear roadmap for reporting outstanding trade populations through the set-up of regulatory reporting OTC derivatives trade repositories. Hereby the industry is leveraging the US-based Trade Information Warehouse (operated by the DTCC) for the credit derivatives. Additional trade repositories for interest rate and equity derivatives will be operational by 31 December 2009 and 31 July 2010 respectively.

It is our view that this transaction reporting mechanism, which is a critical component of market stability and transparency, should preferably be developed and operated by a neutral market infrastructure which is user-owned and user-governed. In a EU context, the markets and the European Commission should consider the ability to leverage the skills, experience and proven resilience in times of market turmoil offered by the European CSD/ICSDs.

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Conclusion

In conclusion, we hope that the European Commission will recognise that in order to enhance the resilience of OTC Derivatives Markets and to improve market transparency and stability, it is preferable to opt for a policy framework that not only focuses on the professed merits of CCP clearing solutions but, in parallel with CCP standardisation, also encourages complementary solutions which also deliver structural risk mitigation. There are significant opportunities to leverage existing market solutions, which may facilitate and accelerate the implementation of one or more infrastructure solutions for the European OTC derivatives markets.

We remain available to discuss the above proposals and information with the Commission.

Contacts

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ANNEX: Product features of DerivManager

Building on its expertise in risk management and collateral management and in close consultation with the market, Euroclear launched DerivManager in November 2007. DerivManager is an exposure management and collateral management tool for OTC derivatives which bridges the gap between portfolio reconciliation and collateral calls.

DerivManager provides a significant next step in the post trading space for OTC derivatives by moving the derivatives industry on from trade reconciliation to dispute resolution, STP collateral management and risk mitigation for all asset classes (including equity derivatives).

DerivManager helps both counterparties to a trade to better understand and manage their positions. By giving access to a comprehensive bilaterally agreed and viewable collateral call and providing counterparties with tools to mitigate:

- Operational risk by reconciling their portfolio;
- Counterparty risk by addressing exposure management and collateral management; and
- Collateral settlement risk

DerivManager is an open and standard solution which can be industrialised and also allows for interoperability with other providers in the post trading space.

Comprehensive reporting includes:

- Trade reconciliation reporting;
- Dispute management reporting including bell curves with the distribution of disputes;
- Comparative portfolio reporting from one day to another, detailing new trades, expired trades and trades continuing to exist with the Mark to Market value evolution; and
- Collateralisation reporting

All reporting can be tailored per product class, maturity date, counterparty, status, etc.

In short, DerivManager:

- Allows banks to focus on mismatches and exposure discrepancies by introducing standardisation and automation;
- Delivers a solution which also covers the non-standardised contracts where often real challenges and risks lie;
- Standardises the dispute resolution process and allows collateralisation of the disputed exposure;
- Automates the full process between trade and collateral (STP); and
- Offers a collateral management solution that is highly secure, allows the use of different types of collateral and ensures independent valuation.