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Submission on Derivatives and Market Infrastructures

Public Consultation by the European Commission Directorate General Internal Market and Services

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About WEED

WEED – World Economy, Ecology & Development is a Berlin based specialist think tank and advocacy organization that has worked on global finance issues for about 20 years. It has outstanding expertise on the development impact of the international financial system. WEED regularly testifies to the German parliament, and recently also to the IMF on financial transactions levies. WEED has been part of several EU funded projects on international financial markets, currently implementing two of them (one of them called "Towards a Global Finance System at the Service of Sustainable Development"). For more information please see www.weed-online.org.

General remarks

As Gary Gensler, head of the CFTC, testified to the European Parliament on 16 March 2010, *"OTC **derivatives were at the center of the 2008 financial crisis.** They added leverage to the financial system with more risk being backed up by less capital. U.S. Taxpayers bailed out AIG with $180 billion when that company's ineffectively regulated $2 trillion derivatives portfolio […] nearly brought down the financial system. As we later learned, much of the bailout money flowed through AIG to U.S. and European banks. These events demonstrate how over-the-counter derivatives – initially developed to help manage and lower risks – can actually concentrate and heighten risk in the economy and to the public."*[1] Also, the Consultative report "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs" from May 2010 notes that the ***"crisis highlighted a severe lack of market transparency in OTC derivatives markets"***[2]**.**

The obvious failure of derivatives stands in stark contrast to the measures discussed and taken so far in this respect. Therefore, we welcome the consultation paper as a step in the right direction. Clearing of derivatives is one measure to mitigate the risks related to them. As the IMF states in his Global Financial Stability Report of 13 April 2010, "centralized derivatives clearing would aid the financial system". However, details of the implementation can make a huge difference in the success of the legislation. **We consider it most important to clear as many derivatives contracts as possible, ideally all, and impose strict regulation on them. We think that it was best to trade all derivatives on exchanges.**

It should be investigated more in detail what economic advantages really stem from derivatives even if they were traded more transparently than before. As the crisis has shown, the risk transfer facilitated by derivatives is indeed only a transfer: the risks are not neutralized. It is obvious that the financial crisis happened while the allegedly risk-mitigating derivatives market was as big as never before. **It is thus reasonable to ask in how far derivatives only hide risks and if these risks could be dealt better with in other ways as it was the case in the times when derivatives were not such an important part of our financial markets.**

Further economic research is utterly necessary, especially on a macroeconomic basis, covering the impact of the current crisis. Also, it should be carefully assessed who has the true benefit of today's financial market structure and dominance, and who is being harmed by derivative trading: the financial gains made by some speculators often mean that many others in the system are paying more, as the futures markets are considered to be a zero-sum game. **The often quoted benefit of derivatives for end user's needs is dubious, especially for small and medium enterprises. Even the benefit for big enterprises appears not to originate from their genuine business but more from their own financial branches.**

1 http://useu.usmission.gov/031610_gensler.html
2 www.bis.org/publ/cpss89.pdf?noframes=1

We thank the commission for the opportunity to participate in the consultation and would like to comment as follows on the consultation paper:

◆ *I. CLEARING AND RISK MITIGATION OF OTC DERIVATIVES*

◆ *1. Clearing obligation*

Both approaches, the *bottom-up* one as well as the *top-down* one, could be followed at the same time. However, the ***top-down* approach should be the one which has to be implemented in any case** because experience in diverse fields has proven that the public can not rely on the self-regulation of the markets. This is exactly what the crisis has taught us.

However, we think the reasoning of the European Commission does not go far enough. Even if there was full CCP clearing, risks still could be left over. Therefore, it was the **best to bring all derivatives to exchanges**.

◆ *2. Eligibility for the clearing obligation*

Regarding the scope of the clearing obligation, the experience of the financial crisis makes it imperative to leave no loopholes. Therefore, **clearing on a CCP should be obligatory for all derivative contracts;** no exemptions should be allowed. As hedge fund manager Michael W. Masters testified to the US Financial Crisis Inquiry Commission on 30 June 2010*, "nearly all OTC derivatives could have cleared through a Designated Clearing Organization (DCO). In fact, the International Swaps and Derivatives Association (ISDA) has long published guidelines for standardization of all derivatives agreements, for example. For those derivatives that could not clear, we would do well to question the social utility of allowing financial instruments of such an extremely esoteric nature to affect the behavior of the US economy."*[3] It is also worth noting Masters' following statement: *"Various OTC derivatives dealers have argued against increased transparency regulation, claiming that it would remove liquidity from the system. The truth is that regulation to increase transparency would have quite the opposite effect."* Furthermore, if not all derivatives were cleared and covered by regulation, the **danger of evasion and regulatory arbitrage will be always very high.**

One reason to make clearing obligatory is the **weak incentive by the financial sector itself to make use of CCPs**. As the IMF Working Paper No. 10/99 by Manmohan Singh (Collateral, Netting and Systemic Risk in the OTC Derivatives Market) puts it: *"Since CCPs would require all positions to have collateral against them, off-loading a significant portion of OTC derivatives transactions to central counterparties (CCPs) would require large increases in posted collateral, possibly requiring large banks to raise more capital. These costs suggest that most large banks will be reluctant to offload their positions to CCPs"*[4]*.* The IMF in its Global Financial Stability Report of 13 April 2010 states that *"if incentives do not work, it may be necessary to mandate movement of contract to CCPs to overcome the reluctance some may have with being first movers"*[5]*.* However, given the crisis we face, we recommend not to wait for the failure of a voluntary use of CCPs, but to make CCP clearing mandatory immediately for all derivatives.

To mitigate risks in the derivatives market, **all derivatives have to be checked and approved by ESMA before being permitted to the CCP**. The emitters should have the obligation to prove that there is a hedging need and that there is no unmanageable individual or systemic risk.

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3 www.fcic.gov/hearings/pdfs/2010-0630-Masters.pdf

4 http://www.imf.org/external/pubs/ft/wp/2010/wp1099.pdf

5 www.imf.org/external/pubs/ft/survey/so/2010/POL041310B.htm

◆ ***4. Non-financial undertakings***

We agree that it is necessary to have a system that reflects the economic and financial hedging needs of corporate end-users. However we think that it would be necessary to have a clear and narrow definition of commercial end-users, with no loopholes for financial entities. A model could be the US legal definition which allows end-user exemption for an entity *"who, as its primary business activity, owns, uses, produces, processes, manufactures, distributes, merchandises, or markets goods, services, or commodities (which shall include but not be limited to coal, natural gas, electricity, ethanol, crude oil, gasoline, propane, distillates, and other hydrocarbons) either individually or in a fiduciary capacity."*[6] All other entities have to be considered as financial entities, with the consequence of all due regulation.

◆ **5.** ***Risk mitigation techniques for non-cleared contracts***

As has been said already above, we actually consider it necessary to **clear all derivative contracts**, thus leaving no loopholes.

If, however, there will remain non-cleared contracts, **strict conditions** should be set by the ESMA, including **margin requirements.** Also, the ESMA should be **informed** about theses contracts and should have the right to intervene if risks associated with these derivative contracts appear to be dangerous. Also, **clearly higher capital requirements** for non-cleared contracts should give an incentive to use CCPs, as also Manmohan Singh in his IMF working paper suggests[7].

◆ ***II. REQUIREMENTS FOR CENTRAL COUNTERPARTIES***

We welcome the EU's view that it *"must in particular be ensured that CCPs will help contain risks in the market rather than potentially becoming a source of systemic risk themselves".* This implies that the CCP itself can not be an investor itself and that the CCPs should not be too concentrated (too big to fail) or to interconnected or linked to too few derivative traders.

◆ ***1. Organisational Requirements***

Basically, we suggest considering if it might be better to have public bodies as CCPs which will be financed by the users. As the failure of the rating agencies has shown, the potential for conflicts of interest is huge in financial markets. As the EU is now officially considering a public EU rating agency, it should also be careful with setting up new private agencies having an important role in the financial markets. Financial market stability is a public good and therefore should not be captured by profit interests. However, the risks related to a CCP have to be taken into consideration too. Of course, the public should not pay if private risk-taking leads to the default of a whole CCP. Therefore, it might also be a possibility to have a private non-profit entity as CCP, which is strictly controlled by the EMSA.

◆ ***2. Risk Committee***

Basically, we welcome the risk committee. However, it should also include **members of the ESMA**.

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6 www.tradeobservatory.org/library.cfm?refID=107466

7 IMF Working Paper No. 10/99, Collateral, Netting and Systemic Risk in the OTC Derivatives Market, http://www.imf.org/external/pubs/ft/wp/2010/wp1099.pdf

The assessments of the risk committee have to be **not only advisory but obligatory to the CCP**.

The **risk assessment has to take into account all possible economic risks**, as can for example be found in the Consultative report "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs" from May 2010[8]. The report mentions risks that will have to be considered by the committee as the following :

- *"In OTC derivatives markets, determining 'normal market conditions' may be a challenge because … there may not be as much market transparency or liquidity as in the context of listed markets or because the correlations between products may exhibit complex contingent behaviours and change suddenly in times of market stress." (3.1)*
- *"There might not be a steady stream of transactions and pricing data that a CCP needs in order to establish mark-to-market prices for its positions. Illiquidity may result from the complexity of the product itself or the lack of a liquid market for related products where risks can be hedged." (3.2)*
- *"Correlations among complex financial products could become unstable in unanticipated ways in times of market stress." (4.3)*

Furthermore, risks should not only be defined as risks for the derivative traders or the financial markets but **cover all economic, social, ecological and other risks and impacts** that derivatives could have, as for example the effects by CDS on the credit costs for Greece. Another example is the devastating effect of excessive food commodity trading on the food prices in 2008. Such risks also have to be taken into account.

◆ *3. Conflicts of interest*

As the credit rating agencies' failures have shown, conflict of interest is a huge problem. We therefore welcome rules on this issue. Additionally, we suggest that employees of the CCP must **not be allowed to buy any derivative that the CCP is dealing with, and not have any professional relations with clients of the CCP** beyond their work for the CCP itself. To underline this danger, we quote hedge fund manager Michael W. Masters, who testified to the US FCIC on 30 June 2010 as follows: *"A holder of OTC derivatives, even where those derivative positions were entered into with the best of intentions, is akin to a poker player forced to play with his cards on display. His opposite party, the derivatives dealer, can see all of his cards, and can therefore exploit this informational advantage to the greatest degree possible."*[9]

◆ *4. Outsourcing*

We welcome the proposed rules and consider it important that they will be implemented. However, the EFSA should **approve any relevant outsourcing in advance**.

◆ *5. Participation requirements*

We welcome the proposed rules but consider it very important to introduce **position limits at the control entity level, aggregated across all trading venues,** respectively limits on the degree of concentration a participant may reach as it has also been suggested in the Consultative report "Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central

8 www.bis.org/publ/cpss89.pdf?noframes=1

9 www.fcic.gov/hearings/pdfs/2010-0630-Masters.pdf

Counterparties to OTC derivatives CCPs"[10] from May 2010. The derivatives market is highly concentrated by now, giving a small group of banks and funds a market power which can not be in accordance with free market principles. Therefore, the CCP should be **able to restrict market participants that are too dominant,** especially in commodity derivatives markets.

All passive investment in the commodity derivatives markets should be banned. This applies to Index Swaps/Funds, Exchange Traded Funds, Exchange Traded Notes and similar. As hedge fund manager Michael W. Masters testified to the Commodities Futures Trading Commission on 8 August 2009 regarding the commodity derivatives markets, *"passive investment provides no benefits to the markets while it exacts a heavy toll."*[11]

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

As said above, we think that the experiences with credit rating agencies have clearly demonstrated the dangers of private, user-paid or even -owned actors in the financial markets. Other models, being public in any sense, should be considered as outlined above (see *1. organisational requirements*). No emitter or counter party of CCPs should own CCPs (e.g. no shareholding), CCP owners should be independent from all actors in derivative trading.

- ***7. Segregation and portability***

We welcome the proposed rules and consider it important that they will be **implemented**.

- ***8. Prudential Requirements***
- ***C. Margin Requirements***

We support the proposed rules and consider it crucial that margin requirements are imposed to **all derivatives**.

- ***D. Default fund / E. Other risk controls / H. Investment policy***

We welcome the proposed rules and consider it important that they will be **mandatory**.

However, we consider it important that the **resources of the default fund and for the other risk controls must not be invested** but deposited with the central bank. In this respect, we refer to our comments above (II. 3. Conflicts of interest). The proposed rule of the EC – that there should only be investment in highly liquid financial instruments – is not sufficient. As the crisis has shown, even presumably highly liquid markets can dry out. So, it might be that the money will not be available exactly if it was most necessary.

Furthermore, investments of the CCP **will create conflicts of interest** because the CCP has an own investment interest which could be contrary to its obligation to oversee risks in the market, or may even rely on insider knowledge doing its investments. Trading on own account by investment banks has proven to be risky and therefore will now be strictly limited in the US.

If trading was allowed, **at least a certain share** of the money should not be invested in order to

10 www.bis.org/publ/cpss89.pdf?noframes=1

11 www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing080509_masters.pdf

secure a minimum liquidity of the CCP in times of severe default.

◆ *III. INTEROPERABILITY*

We support the proposed rules but want to stress that the **regulatory level and risk prevention must not be watered down** and that approval in advance for any interoperability agreement is a must. Agreements should also be **reviewed periodically**. If risks turn out to be unmanageable, limiting interoperability has to be a legitimate regulatory measure even at the expense of less integrated financial markets.

◆ *IV. REPORTING OBLIGATION AND REQUIREMENTS FOR TRADE REPOSITORIES*

◆ *1. Reporting obligation*

We welcome the proposed reporting obligation and are **clearly in favour of option A (reporting any derivative)**. As stated in the consultation paper, markets are not constrained by national borders any more. The consequence also must be that not only EU derivatives should be reported but all. In the crisis, especially in Germany, risks also originated from non-EU derivatives.

◆ *Options for registration of trade repositories*

We are **in favour of Option 3, a European 'public' utility**. As financial market stability is a public good, the information has to be publicly held. The management of this entity could be either done by the ESMA itself, or the ESMA could tender it with clear conditions for the implementation and, later on, strict and permanent regulatory oversight. The costs should be paid for by the participants of the derivatives trade.

◆ *Transparency and data availability*

As financial market stability is a public good and the data is of high interest for the public, it should be **available to the public**. The public availability is also suggested in the Consultative report “Considerations for trade repositories in OTC derivatives markets”[12] from May 2010 (number 3.2, paragraph 1). However, the public availability should not only be limited to aggregate positions by class of derivative as suggested by the EC but as far as possible. For example the BIS/IOSCO report covers the “data recorded in TRs” and states that *“TRs should make publicly available aggregate data on open positions and trading volumes on a periodic basis with geographical and currency breakdowns”*. As non-transparency has lead us into the current crisis, transparency is imperative now and business interest should not impede public data availability.

Contact: **WEED – World Economy, Ecology and Development**
Markus Henn
Eldenaer Str. 60
D-10243 Berlin
Phone 0049-30-27582249
Email markus.henn@weed-online.org

Interest Representative Register ID number: 73788681242

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12 www.bis.org/publ/cpss90.pdf?noframes=1