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One size doesn’t fit all

Amid the swathe of proposed regulation issued by European regulators, the latest consultation paper from the Committee of European Securities Regulators (CESR) addresses two key areas of over-the-counter derivatives: standardisation and exchange trading.

With the consultation period now closed, the industry has shown that it strongly supports continued progress towards greater transparency and standardising derivatives where appropriate, but in this case, there is a real fear of a regulatory sledgehammer being used to crack the proverbial nut.

Many of the consultation paper’s proposals are welcome and, indeed, standardisation of some aspects of trading OTC derivatives can bring additional benefits to the market participants. For example, in terms of process improvements, the growth of electronic trade confirmations systems is welcomed in dealer-to-dealer trading and there is strong support for standardising documentation and definitions.

CESR also seeks to develop product standardisation which is laudable, yet it is also important to acknowledge the inherently bespoke nature of derivative contracts. The end users of the derivatives contracts can often be non-financial companies who are seeking to mitigate specific risks. This cannot be achieved if we move to a market where all contracts become so standardised that they no longer fully achieve the risk management objective.

Losing all product flexibility, whilst also incurring undue costs from adopting new standards and processes, will create further barriers to entry for customers. Customised OTC products are important for the corporate’s ability to hedge, which, in turn, reduces overall systemic risk. OTC products should be standardised only when driven by market needs and market participants should not be forced to do so.

One of CESR’s proposals is to move all derivatives trading onto organised or exchange trading platforms. However, as the G20 group has already recognised, there needs to be customer choice in terms of how trades are executed a sentiment which AFME strongly supports.

The results of the AFME/Financial News Buyside Trading Poll conducted earlier this year reveals that investors continue to favour OTC/voice trading over electronic or organised trading venues. 29% cited, as the main reason, the ability to trade in large sizes. In addition, 18% noted access to liquidity as the dominant reason. Thirdly, 11% noted that they would choose to trade OTC/voice in time of market volatility.

On the liquidity point, although AFME supports the encouragement of competition, we note that, in times of market stress, liquidity can often disappear from centralised venues and clients often revert to the few dealing houses providing liquidity in the tougher climate.

The most important objective of the regulator is to remove risk and increase transparency in the financial system but there are better ways than standardising products and
mandating exchange trading to reduce systemic risk. This can be achieved whilst still providing the market with product choice and options for execution venues, whether OTC or on organised platforms. For example, the derivatives industry could use trade repositories to enable regulators to monitor the position in the market. Furthermore, market participants, through the work of organisations such as ISDA, continue to work towards making more contracts eligible for clearing, as well encouraging use of central counterparties.

The market has rallied to provide its own insight to CESR on its derivatives proposals, with AFME working jointly with other trade associations in providing its own joint response. The market also needs a degree of flexibility and we trust that the regulator will listen to its concerns - customised OTC derivatives remain important for customers’ ability to hedge and are key to reducing systemic risk.

Similar ways to reduce systemic and operational risk are already being reviewed by existing regulatory initiatives in Europe and across other jurisdictions. European directives, such as the European Market Infrastructure Regulations and MiFID and US legislation such as the Dodd-Frank Act are a few examples. Understandably, this provides additional challenges for institutions as they are constantly dealing with overlapping regulatory initiatives which are all trying to reach similar objectives.

We are hopeful that industry and regulators can work together to provide a harmonised approach to the regulatory and market-led initiatives already underway.