CNB CZECH NATIONAL BANK

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CZECH REPUBLIC

Public Consultation:

DERIVATIVES AND MARKET INFRASTRUCTURES

Opinion of the Czech National Bank

In General

In line with earlier opinions we believe that the regulation proposed by the Commission is too wide-ranging, is focuses on issues which need no regulation, and, where regulation is proposed, is too rigid. We have in mind chiefly the introduction of mandatory clearing of derivatives transactions through central counterparties (CCPs) for all financial institutions regardless of their degree of involvement in transactions and their significance for the market in specific types of derivatives. The purpose of clearing transactions through CCPs should be to reduce counterparty risk for systemically important financial institutions. However, the costs of access to clearing through CCPs may be too high for some participants.

We believe that the introduction of a clearing obligation and the proposed access to regulation of central counterparties will lead to an increase in their systemic importance, probably to a level where the systemic risk will reach or exceed major financial groups in the EU. Central counterparties then may be too big to fail. The consequences of the above proposals thus go against the present considerations regarding the reduction of systemic risk arising from the activities of large companies operating on the financial market.

In general we favour an approach based on the initiative of the market, or CCPs, to clear the relevant derivatives contracts and we are definitely against European supervisory authorities being able to determine which derivatives contracts the CCPs are obliged to clear. If harmonised standards are adopted, both the authorisation and supervision of central counterparties should to be left to the national supervisory authorities. In addition, central counterparties will become systemically important institutions and it cannot be ruled out that in exceptional situations it will be necessary also to provide financial support (liquidity, solvency), which cannot be ensured by ESMA. In our opinion, the role of ESMA should consist mainly in harmonisation (standard creation) and registration activities. We can also imagine the ESMA playing role in the recognition of third country CCPs.

We have no fundamental comments on organisational requirements, risk management rules and rules of conduct for CCPs (they should be comparable, for example, with regulated markets or investment firms), but nonetheless we believe that only basic principles of activity should be laid down in law and more specific organisational requirements for CCPs should remain in the form of recommendations (see, for example, the existing ESCB-CESR recommendations). Licensing and supervision of CCPs, as well as the setting of requirements for the control systems of all regulated entities, should be exclusively in the competence of national supervisory authorities.

We are totally against any principles that would be superior to different national regulations (e.g. the account segregation requirement). The introduction of such principles must be

preceded by analyses and careful consideration of the private law impacts in individual jurisdictions.

We believe that one of the main objectives of trade repositories is to ensure transparency, but the Commission envisages all OTC derivatives transactions being reported to trade repositories. However, a large proportion of OTC derivatives are used to hedge against risks based on individual needs, especially those of non-financial institutions. Information on the prices and volumes of such transactions is not meaningful from the point of view of market participants, so we do not see any reason from the transparency perspective for reporting it to trade repositories (transparency is useful only if product standardisation allows for price comparison). The situation with the low information value of data from transaction reporting under the MiFID (TREM) may serve as a warning.

The establishment and operation of trade repositories will entail considerable costs, which will be borne by market participants. Given the assumed existence of more than one trade repository, costs will also be incurred by supervisory authorities because of the need to aggregate information obtained from trade repositories. The question is whether the information from trade repositories will be used effectively for supervisory purposes, or whether the benefits for supervision will be commensurate with the costs incurred by the industry. We also deem it necessary to note that when creating reporting requirements for OTC derivatives it is necessary to resolve potential duplications with the existing national disclosure duties. We still want to see a cost-benefit analysis of the establishment of trade repositories.

CLEARING AND RISK MITIGATION OF OTC DERIVATIVES

Questions:

What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivate contracts for mandatory clearing, and its application? Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?

In general we favour an approach based on the initiative of the market, or CCPs, to clear the relevant derivatives contracts and we are definitely against European supervisory authorities being able to determine which derivatives contracts the CCPs are obliged to clear.

We therefore agree with the bottom-up approach, on the basis of which the CCP itself will decide that it wants to clear certain types of contracts and will apply for the national regulator’s consent. If it is also decided to apply the top-down approach, the CCP interested in clearing the contract must obtain clearing approval from its home supervisory authority as in the bottom-up approach.

The obligation of clearing through a CCP in the case of a contract with a counterparty from a third country should be set only if such counterparty has a similar obligation in its own jurisdiction. In the opposite case, counterparties should be given contractual freedom to agree to clear either through a CCP or on a bilateral basis.

As regards access to CCPs, we believe that the CCP should itself specify the conditions for participation in its system, i.e. consider all risks arising from the participation of specific financial institutions.

Non-financial corporations

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?

We prefer complete exclusion of non-financial institutions from mandatory clearing of OTC derivatives transactions in order to minimise the effects of regulation on the corporate sector. However, the approach proposed by the Commission, i.e. the setting of thresholds for informing the regulator and for the obligation to clear a transaction through a CCP is an acceptable compromise allowing only those non-financial institutions which are relevant in terms of volume of transactions or value of open positions to be covered. We also presume that both thresholds will be subject to expert discussions and will be set so that mandatory clearing through CCPs will really cover only the most significant corporate institutions.

At the same time, however, we deem it necessary for similar thresholds to be applied also to small financial institutions, which do not pose a risk to the financial sector. In the CNB's opinion, this procedure does not conflict with the G20 conclusions, which were aimed at reducing systemic risk, i.e. focusing on systemically significant OTC derivatives market participants. There is no reason to apply the same regulation to financial institutions that carry on a limited volume of transactions and whose open positions are very limited. Such financial institutions should have the option of deciding whether to clear derivatives contracts through CCPs or on a bilateral basis given appropriate counterparty risk management.

Risk mitigation techniques for non-cleared contracts

Question:

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

In general we agree that on a bilateral level both parties to the contract must have sufficient knowledge and techniques to manage risks arising from derivatives transactions.

At the same time, however, we deem it necessary for the conditions (particularly capital and collateral requirements) stipulated by the new regulation to be not too costly or meant as a penalty. The CNB supports the setting of capital requirements at the level corresponding to the risk, but not as an instrument for directly influencing the market infrastructure. We therefore agree with the principle that capital requirements in bilateral contract clearing will be higher owing to their higher risk. We are, however, totally against excessive penalty capital requirements for derivatives contracts, which are used primarily to hedge the risks of the corporate sector. The new regulation must not be aimed at preventing bilateral OTC derivatives contracts.

REQUIREMENTS FOR CENTRAL COUNTERPARTIES

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?

The introduction of too extensive mandatory clearing of derivatives contracts through CCPs will mean that CCPs will become systemically important financial market institutions. For this reason we recommend that the CCPs meet certain requirements regarding control systems, taking into account the significance and character of their activities, particularly in terms of risk management. The system should be based on the standards applied to other financial institutions, but should always correspond to the scope and character of the activity of CCPs.

We still favour only basic principles being regulated by law and more specific requirements for the control systems of CCPs being set in the form of recommendations (see for example the existing ESCB-CESR recommendations). Final responsibility for CCP supervision lies with home supervisory authorities, and the setting of specific requirements for CCP activities should also remain in their competence.

Segregation and portability

Questions:

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

We agree with the requirement to segregate assets (accounts) on the part of both the CCP and its participants. We believe that only in this manner is it possible to identify the specific positions and collateral of individual clients in the event of default.

We have serious doubts as regards the Commissions intention that above mentioned principle will be superior to different national regulations. We believe that its introduction should be preceded by analyses and careful consideration of the impacts on the private law nature of securities holdings in individual jurisdictions. Possible conflict with national regulations may have far reaching consequences and mere statement that this principle is superior to national regulations may not in practice have intended results.

Prudential Requirements

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?

In general we agree with the setting of prudential requirements at a similar level as in the case of other financial institutions. We believe that initial capital should not be lower than in banks. In view of the systemic risk, a CCP should use a wide range of risk management and

coverage instruments, i.e. from a default fund and collateral requirements through to credit lines or insurance.

As mentioned above, national supervisory authorities must also have the option of setting conditions for the activity of CCPs subject to their supervision.

Relations with third countries

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?

In general we agree that given the global nature of service provision by CCPs we should not overlook licensed and supervised third country CCPs whose regulatory and supervisory framework can be considered comparable with that in the EU. The document does not make clear the scope and purpose of the agreement between supervisory authorities. We believe that there must be an agreement not just between the individual member states, but across the EU as a whole. We recommend that ESMA should take the coordinating and negotiating initiative.

The Commission should also address the issue of the disagreement of some competent authorities with the above agreement and also the procedures to be applied in the event of a breach of this agreement by a third country.

INTEROPERABILITY

Question:

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

We agree that the post-trade infrastructure is very fragmented across the EU and its gradual integration is thus desirable. Interoperability of clearing systems is provided for in both the Settlement Finality Directive and the Code of Conduct, so it is only logical that it should also be supported in the emerging CCP legislation.

It is clear that interoperability between CCPs widens the range of risks that interoperable systems must face and that those risks must be dealt with appropriately. We therefore consider a requirement for approval of risk management rules between interoperable systems to be necessary.

REPORTING OBLIGATION AND REQUIREMENTS FOR TRADE REPOSITORIES

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

We believe that the trade repositories issue has several aspects. It is clear that the global nature of this service prevents activities from being limited to the EU, i.e. the use of third country TRs should be allowed. At the same time, however, we deem it necessary for a consensus to be reached at international level on both the conditions for their activity and the technical standards for reporting. Any legal regulation at the EU level should come only afterwards. In the opposite case there is a danger that TRs operating outside the EU will not meet the requirements, ESMA will not register them and there will be nobody to report to.

In this connection we deem it necessary to mention the issue of financing TRs' activities, which has not been yet addressed at all. The establishment and operation of TRs will entail considerable costs. It can be assumed that TRs as private entities will charge fees to transaction participants for storing information about contracts and probably also to regulators for providing information. The question is whether the information from TRs will be used effectively for supervisory purposes, or whether the benefits for supervision will be commensurate with the costs incurred by the industry.

In the case of a TR in the form of a single "public" or non-profit utility dealing with data collection, publication and provision, costs can be expected to be incurred mainly by regulators, who will be the primary users of the data.

As the Commission plans for all transactions to be reported to TRs, i.e. including those cleared through CCPs, we are afraid that the costs of such contracts will increase. The EC's proposal should therefore prevent double reporting of contract data as far as possible, in view of, among other things, potential existing similar reporting in the Member States.

We believe that TRs' activities could be replaced by reporting to national regulators, who would exchange the information.

Requirements for trade repositories

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?

As in the case of the requirements for CCPs, we support setting requirements for trade repositories primarily in relation to the scope of their activities and the risks they have to face.

TECHNICAL REFERENCE GLOSSARY OF DEFINITIONS

Questions:

Do stakeholders agree with the definitions set out above?

We have not identified any disagreement so far.