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Response by the Swedish authorities to the Consultation by the Commission on Derivatives and Market Infrastructures

The Riksbank (the central bank of Sweden) and Finansinspektionen (the Swedish Financial Supervisory Authority) welcome the efforts to improve the European market infrastructures and appreciate the opportunity to respond to the Consultation on Derivatives and Market Infrastructures. A well balanced regulation for derivatives markets is essential for economic growth and financial stability. We deem that time used in developing good regulation will prove to be well invested.

Our comments on the proposal outlined in the consultation paper are found below. Before answering some of the specific questions in the consultation we have some comments of a more general character.

General comments

First, according to the Riksbank and Finansinspektionen, coordination with other international work is highly important. Therefore, the work being done on a European level needs to be coordinated with other international work such as the existing ESCB-CESR standards, the CPSS-IOSCO's general review of their standards and the legislative initiatives in other jurisdictions. It is important to achieve internationally harmonised rules and thereby increase efficiency and avoid regulatory arbitrage.

Second, we prefer an open-ended regulation that to a larger extent is based on principles. The detailed regulation should be left to ESMA. That way, the EU will be more compatible with international standards and best practices. A very detailed regulation is running the risk of becoming obsolete but also to reduce the compatibility with international standards.

Third, we favour a bottom-up approach which more clearly involves the CCPs, the competent authorities and ESMA. It is important to stress that the incentives will always rest with the industry.

Specific comments

I. CLEARING AND RISK MITIGATION OF OTC DERIVATIVES

We share the Commission's concern that the clearing obligation for OTC derivatives contracts should be formulated so that it decreases systemic risk rather than increasing it. While ensuring a more efficient financial infrastructure, it is also important to secure that the regulation (or the technical standards) preclude the possibility for CCPs to compete in a "race to the bottom" by offering the lowest margin requirements, the lowest capital cushions, or the lowest contributions to the default fund and thereby increasing risks to the wider economy.

Our concerns cover not only the clearing obligation itself and the regulation of CCPs but also the incentive effects which this regulation creates, its effect on market structure and its interaction with other ongoing legislative work. Our concerns about market structure focus on how the clearing obligation will redefine the types of institutions which can do OTC derivatives business and how it will affect liquidity in smaller markets such as markets for Swedish OTC derivatives. These issues need to be analysed thoroughly as part of the legislative process.

Irrespective of the sort of financial regulation, it is only possible to decrease the risk of CCPs defaulting but impossible to avoid it completely. It is therefore imperative to discuss how to handle a default of a CCP. Such a default is also likely to have cross border implications. The work on how to manage a defaulting CCP or other problems affecting the stability of the derivatives market or infrastructure should preferably be done in connection with the work concerning crisis management of credit institutions.

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?

Clearing obligation

The Riksbank and Finansinspektionen would like to underline that requiring counterparties to have solid risk management in combination with an adequate capital requirement on contracts not cleared through a CCP would in itself create plain incentives to use a CCP. This could be an alternative to imposing far reaching clearing obligation through regulation.

The Riksbank and Finansinspektionen do not support the position that the clearing obligation should also apply to financial counterparties which enter into eligible derivative contracts with third country entities. Avoiding regulatory arbitrage is important but this should not be achieved by imposing the clearing obligation on third country entities. Instead, risks arising from such contracts can be monitored by proper risk management procedures. An alternative is to impose a clearing obligation on transactions with third country entities only if similar rules on clearing obligation are applicable to the third country entities. If clearing obligation should apply for

contracts with third country entities, we want to stress the importance of global coordination.

Eligibility for the clearing obligation

The Riksbank and Finansinspektionen favour the bottom up approach. At the end of the day, the initiative will always rest with the clearing industry.

When deciding if a class of derivatives is eligible for clearing in the top-down approach, a key element is the objective criteria established for this purpose. However, the consultation does not identify these criteria. Without having a clear picture of which criteria that will be the basis for the decision on eligibility, it is not possible to give detailed comments on this subject.

Access to a CCP

The Riksbank and Finansinspektionen fully endorse all rules guaranteeing free and open access to market infrastructures. However, the Commission's requirement to accept eligible derivatives contracts regardless of the venue of execution may need to be defined more clearly. Accepting derivatives contracts may require costly infrastructure or cooperation to link the CCP to the venue. There may well be no business case for incurring these costs.

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

Including non-financial counterparties will increase the cost of regulation as these counterparties typically do not hold the liquidity necessary to collateralise their exposures. As banks will likely lend them the collateral, clearing for non-financial counterparties will not necessarily reduce banking exposures. However, in a crisis, a bank could stop lending to the counterparty and let the CCP manage the counterparty's default on its OTC position. Excluding them will exclude some large players. More importantly, excluding them will open for arbitrage both at the border between financial and non-financial counterparties and possibly also across jurisdictions.

Setting a threshold for covering non-financial counterparties would eliminate some of the problems of including them but would introduce measurement problems. The measurement problems include questions of how to measure the value of outstanding OTC derivative positions, whether a large corporation can divide its derivative positions among subsidiaries and how fluctuations in the value of exposures will be handled.

An alternative is to exclude non-financial counterparties and require adequate capital requirements for bilateral clearing with such counterparties.

We do not yet have a clear position on which would be the most appropriate approach for non-financial counterparties. On one hand it is important to increase in the resilience of the financial system. On the other hand, it is difficult to get a clear picture of what the effect of different legislative approaches would be. The pros and cons with different solutions should therefore be thoroughly investigated in

connection with the proposal for a regulation. It should also be investigated how a future regulation on Derivatives and Market Infrastructures relates to provisions in the Settlement Finality Directive 98/26/EC, amended through Directive 2009/44/EC on inter alia the definition on system and whom that may be a participant in a system.

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

The Riksbank and Finansinspektionen believe that financial institutions should manage the counterparty risks associated with non-cleared contracts stringently in accordance with best practice for counterparty risk management and collateral. We question whether it is reasonable to impose a similar requirement on non-financial counterparties. If it is intended to be introduced, it requires much more analysis. For example, what would happen to a firm whose exposures reach systemic proportions for a short period of time and which tools should the authorities be equipped with to enforce the risk mitigation requirement.

II. REQUIREMENTS FOR CENTRAL COUNTERPARTIES

We would like to stress the importance of European regulation being compatible with the results of the CPSS-IOSCO general review of standards in order to reach global harmonisation. Requirements for central counterparties need to be sound, adaptable to the entire range of institutions acting in Europe and preferably harmonised globally. However, the provisions below seem to be a combination of more general principles and details. To be able to create a uniform global market, the level of details must decrease.

Do stakeholders share the general approach set out above on organisational requirements for CCPs?

The Riksbank and Finansinspektionen find the organisational requirements for CCPs to be sound.

In particular comments are sought on the role and function of the Risk Committee; whether the governance arrangements and

The Riksbank and Finansinspektionen disagree with the principles for the composition and functioning of the Risk Committee. The principles seem to be based on an assumption that the owners of a CCP have no incentive to provide adequate risk management. In our view, owners of CCPs are likely to have strong incentives to manage risks, regardless of ownership structure (private, public or mutual). Also, inefficient risk management will put the capital and reputation of the CCP at stake. In addition, other related business such as trading or technology businesses can also be affected negatively by lax risk management. In effect, owners may have even more incentive to control and limit risks than users do.

If however a more detailed approach is taken, we propose that the provision in paragraph (d) should be deleted. We see neither the reason for the CCP to promptly inform the competent authority, nor what the consequence of such a notice will be. The risk committee has only an advisory and not a decisive role. An alternative would

be to require the CCP to document the cases where an agreement cannot be reached between itself and the risk committee and to submit it to the competent authority upon request.

and participation and transparency requirements?

The principles suggested here are in some ways too detailed but nonetheless leave out important aspects. We suggest high level principles that the CCP should disclose information so that its participants and their clients can calculate the risks and costs associated with using the CCP's services.

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

No specific rules on ownership should be established. The Riksbank and Finansinspektionen hold the view that different ownership models: public, private and mutual ownership have benefits and drawbacks for risk management, control and efficiency. Rather, the competent authorities will have to adapt their tools to the different ownership structures

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

The approach seems in line with regulatory objectives and we agree that clients who have a guarantee of full portability should face a capital requirement equivalent to that levied for exposures to a CCP.

Do stakeholders share the general approach set out above on prudential requirements for CCPs?

We agree that the areas covered are appropriate but the following aspects must be considered. In Europe, some CCPs are large, some small; some clear equities, some OTC derivatives and some work in major global markets while others are only active domestically. If the Commission chooses to write detailed requirements it must make certain that they are applicable to the full spectrum of CCPs.

As a general remark, it is important to ensure that the CCP at all times maintains sufficient available financial resources to cover potential losses that exceed the margin requirements. Whether this is in the form of a default fund or own capital is of less importance. In addition, some part of these financial resources may be covered by insurance from external parties.

In particular: what should be the adequate level of initial capital?

Since the capital requirement should be fulfilled at all times and not only initially, it does not seem entirely correct to call it "initial capital". Furthermore, it could probably vary over time (compare articles 9 and 75 in Directive 2006/48/EC).

We therefore propose that paragraph (a) introduces the minimum level of initial capital, which should be available initially. Paragraph (b) on the other hand should state how to calculate the level of capital for a going concern.

Margin requirements

The Riksbank and Finansinspektionen are of the opinion that the regulation on margin requirements should contain overall principles and that ESMA should establish technical standards.

The present wording is a mixture of principles and details. For example it is stated that the margins should be sufficient to cover losses that result from at least 99 per cent of the price movements over an appropriate time horizon. However, it does not indicate how many liquidation days the margins should cover. This is not coherent.

Other risk controls

We have some comments on paragraph (a).

Given that the Member States do not wish to go further than the international standards do, then this regulation should not comprise detailed rules stating that the financial resources may include insurance arrangements, parental guarantees etc. The details should be left for ESMA to develop through technical standards.

Also, paragraph (a) should be more restrictive and coherent with the current ESCB-CESR standards, in particular RCCP5.

A concern with the current proposal is that it opens up for a range of financial resources of different qualities and also of different accessibility. It is important that it is clear how a CCP will have access to sufficient resources of sufficient quality in stressed scenarios. The possibilities in a crisis to use funds from the own capital, default fund, parental guarantee or from an insurance have to be assessed. It is also important that the guiding principles are harmonized when it comes to the quality of the financial resources.

Should the default fund be mandatory and what risks should it cover?

A CCP needs financial resources to fulfil its obligations when a counterparty defaults. However, we do not believe that a participant funded default fund (clearing capital) is the only way to achieve good risk management. The CCP itself can provide the funds. The view of the Riksbank and Finansinspektionen has been that participants' interest in stable markets gives them incentive to monitor the risks of the CCP even if they have not contributed to the default fund themselves. If the CCP provides the funds, it has an incentive to manage risks well and to be proactive in its actions. To allow more flexibility our proposal is to allow the default fund to be created by contributions from the CCP itself. Allowing for different solutions is further important in order to lower the entry barrier for CCPs and enhance competition.

If the Commission decides nonetheless to require participant contributions then we do not think that there should be a minimum requirement for the contribution.

Should the rank of the different lines of defence of a CCP be specified?

No. It does not make sense for the regulation to specify if a CCP should use either a default fund or other financial resources before the participant's pledged collateral

and the participant's own contributions to the default fund has been used. However, the CCP should decide the order in which it uses its funds.

Also, the CCP must provide complete information about the order in which it will use resources, how sufficient funds can be made available, any requirements participants have to replenish a default fund and whether participants have unlimited exposures to the CCP.

We encourage the Commission to note that the CPSS-IOSCO's review of standards encompass liquidity risks. The European markets would benefit greatly if the Commission takes this work into account.

Will the collateral requirements and investment policy ensure that CCPs will not be exposed to external risks?

No. Risk management methods can only minimise not eliminate risks.

Will the provisions ensure the correct management of a default situation?

No. As a detailed suggestion it misses important elements of good default management. For example, ESCB-CESR requires the CCP to make clear what constitutes a default. Also, while the risk committee is defined in detail, there is no mentioning of how a committee (risk committee or default committee) should work.

Are the provisions above sufficient to ensure access to central bank liquidity without compromising central banks' independence?

We do not believe that the provisions ensure access to central bank liquidity at all. They encourage CCPs to provide settlement in central bank money. However we do not believe that they compromise central bank's independence.

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?

The Riksbank and Finansinspektionen agree with the general approach to third country clearing. Allowing for global markets in European legislation will contribute to efficiency.

III INTEROPERABILITY

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

The Riksbank and Finansinspektionen support the initial proposal laid down in the discussion paper accepting interoperability for cash equities and bonds as a first step. After a given period of time, an evaluation of the interoperability arrangements must be made to find out the benefits and difficulties created by interoperability. It is sensible to wait with any interoperability arrangements for OTC derivatives since those products are more complex and different in nature than cash equities and bonds.

IV REPORTING OBLIGATION AND REQUIREMENTS FOR TRADE REPOSITORIES

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

The Riksbank and Finansinspektionen believe that any locational restrictions on trade repositories would be counterproductive as would any attempt to divide markets geographically for reporting. It is important that authorities form a complete picture of counterparty's positions.

In particular, we would like to stress the importance of ensuring that the authorities have unfettered access to information and that this information is consolidated efficiently, e.g. in a trade repository. The intention is to avoid having the competent authorities consolidate the information.

The Riksbank and Finansinspektionen also want to stress the importance for authorities to have access to information about the counterparties' identity even if one of the counterparties is situated outside the European Union. Derivative contracts sometimes include secrecy clauses that make the identity of the counterparty confidential. It is also possible that national law prohibits information about the identity of counterparties to be disclosed.

As stated above, we hold the view that all ownership models: public, private and mutual ownership have benefits and drawbacks. As a result the ownership model of trade repositories should not be regulated.

Further, we would like a deepened analysis about the authority responsible for the supervision of trade repositories. It is suggested that the registration process will be handled by ESMA, but it is not made clear whether that also involves the practical supervision of trade repositories. Furthermore, a trade repository may offer additional services and such activities would be supervised by competent authorities in the home Member State. The supervision under such circumstances would only comprise the latter parts of the enterprise, and such division could create obstacles for the competent authorities in their supervision.

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?

Since the Riksbank and Finansinspektionen strongly support a global approach to trade repositories we also strongly support harmonised global regulation. Thus, European legislation should be fully compatible with the final requirements embodied in the "CPSS-IOSCO Considerations for Trade Repositories in OTC derivatives markets" which recently have been under consultation.

We also suggest that the data availability is regulated through guidance. Such guidance provides information to the trade repositories about what kind of information the authorities are entitled to.

Furthermore, we believe that more clarification is needed regarding the access to information from trade repositories. The idea that all relevant authorities in the European Union shall have unfettered access to the information, in order to perform their statutory functions, is generally restricted to information regarding the institutions that are under the supervision of the respective authority.

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