EUROPEAN PARLIAMENT COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS
Public Hearing on OTC Derivatives
Brussels
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15.15 - 15.25 INFRASTRUCTURE PROVIDER (10 minutes)
Henrik Paulsson, Senior Vice President, Responsible for European Derivatives, NASDAQ OMX

NASDAQ OMX is a global actor in the exchange industry, and we operate the famous NASDAQ stock market. We also operate markets all over the world. We provide exchange technology to over 70 markets in 50 countries.

In the field of European Derivatives we operate an exchange and clearinghouse based in the Nordic region.

We do equity and equity related derivatives, we do fixed income and commodities. In commodities I'd like to highlight our world leading, innovative market for power derivatives, the old Nord Pool.

We do derivatives from 9 countries and handle 6 currencies.

We list options, futures, forwards swaps. We clear exchange traded and OTC contracts.

In OTC markets, we clear standardised contract, but we also operate a FLEX-service, allowing participants to tailor-make the terms and conditions of the derivative in question.

We need to develop stable financial markets to help develop the European economy.

- Exchanges and CCPs have been created to serve this goal and have proved resilient during the crisis. Throughout the financial crisis they have delivered continuous access for all investors to transparent and well-regulated marketplaces and, in doing so, have provided stability and confidence to a sorely tested financial system. In fact, the crisis revealed the importance of sound market infrastructures such as exchanges and clearing houses which stand between the contracting parties and provide safety and neutrality.

- The derivative markets are useful for economic actors to handle risks although they can create systemic risks when not managed adequately. The financial crisis demonstrated how over-the-counter derivatives – initially developed to help manage and lower risk – can actually concentrate and heighten risk in the economy. For instance, Credit Default Swaps played a major role in the difficulties experienced by the insurer AIG which lead to a massive bailout by the US government.

- As a result of the crisis, the G20 leaders agreed that "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end 2012 at latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements". We believe it is important to implement these principles swiftly.

Benefits of transparency and central clearing

- The benefits of central clearing over bilateral risk management arrangements are many. Mitigation of counterparty risk: a CCP acts as a buyer to all sellers, and vice versa (a process called contract novation). This allows the CCP to assume the

counterparty risk of all trading parties and ensure sufficient collateralization through (intraday) margin calls. Complexity in counterparty relations and monitoring costs are thus substantially reduced.

- The CCP is well protected against default by the collateralization of open risk positions and by its ability to close out positions and by its several lines of defense. Additionally, the CCP nets all offsetting open derivatives contracts of each trading party across all other trading parties. Such multilateral netting decreases the gross risk exposure to a much higher degree than through bilateral netting. Furthermore, a CCP is in a better position than any counterparty of a bilateral transaction to absorb the failure of a clearing member. By specifying the requirements for clearing members' margining and collateral, CCPs are able to reduce the risk of a failing member affecting others.

- Putting central clearing and bilateral collateralization (or what is also referred to as bilateral clearing) on an equal footing is misleading. That said we recognize that certain instruments because they are tailor-made cannot be centrally cleared as a CCP would not be able to evaluate the inherent risks.

- Should the risk of CCPs becoming systemic bar the reform? No. At the moment in terms of risks the market is trying to catch a black cat in a black room, CCPs will allow to turn on the light and to catch the cat. Obviously, one still needs to deal with the black cat but it is much easier with the light on and CCPs are equipped as their function is mainly to manage risk.

Good regulation of CCPs is key

- Restoring the stability of financial markets through wider use of CCPs justifies that the regulation applying to CCPs is reviewed in order to check and improve, if necessary, the robustness of such entities.
- CCP are in their capacity and functionality better built to manage the risks. Nevertheless, as a lot more derivatives become cleared by CCPs after political and regulatory changes, it becomes increasingly important that CCPs are well regulated.
- A new, robust pan-European regulation of CCPs is an essential part of the new legislation.
- Regulations should include rules on e.g.
    - Governance
    - Risk Management, incl. Risk Committee
    - Capital requirements
    - Segregation and portability
    - Requirements on participants
    - Independence
- Independence of CCPs is important to allow autonomous risk management.
- Regarding risk committees: the involvement of users in discussions on risk management to ensure development of the most appropriate new functionalities and services is necessary. We would welcome suggestions to expand advisory groups into risk committees including an equal number of indirect participants and direct participants, believing this will further contribute to ensuring that the needs of the market are met.
- Any proposal on the formation and functioning of a risk committee need to be carefully considered to ensure a continued advisory role and avoid shifting decision-making power away from the CCP.

Benefits of exchange trading for derivative instruments

- Transparency of pricing through exchange trading brings further benefits to the broader financial system. By requiring certain OTC derivatives to be traded through exchanges, transactions are executed in the most economically efficient ways.

- This has the potential to significantly reduce the cost for OTC participants who are hedging their risk.
- In addition, exchange trading brings open and neutral access to markets, not least in times of turmoil.

Treatment of corporate end-users

- Corporate end-users need to have the ability to use derivatives to hedge their risks. They will continue to be able to do this with central clearing. Typically, the price they have paid for these derivatives logically incorporates the risk of the transaction. They have been paying margins in one way or another.
- We need to recognize that not all corporate end-users pose a systemic risk and should be submitted to a central clearing obligation but above a certain level of involvement in the OTC derivative market central clearing should be imposed on corporate end-users. We should not forget about Enron and AIG and their devastating behaviors.
- In the past, some corporates, such as Metallgesellschaft or Procter and Gamble, have used derivatives to speculate. However, it is so difficult to segregate between hedging and speculation depending on the potential use of derivatives that it would not be practicable and would render the whole reform ineffective.
- In any case, the overall market will benefit from more transparency. Hence, registration in a trade repository should be a minimum requirement but is not sufficient.

Should interoperability of clearing houses be required?

- It can be pointed out that in some markets, the industry has driven and achieved interoperability of CCPs for cash equities. Interoperability is functioning for the UK and Swiss markets. There are also a number of markets for cash equities currently working towards implementing competitive clearing. For instance, NASDAQ OMX is working towards such interoperability in the Nordic markets. Some interoperability arrangements are pending review by regulators who have expressed concern about the complexities involved and new or elevated levels of risks, including operational, technical, legal, settlement, liquidity and counterparty risks.

- Given the focus on laying the right groundwork to ensure financial stability in the future as well as the need to enhance market integrity to avoid future financial crises, combined with industry progress and ongoing regulator assessments, the grounds for mandatory interoperability among CCPs are unclear. We believe that it would be difficult to, at this point in time, clearly define a model for interoperability that could be mandated.

Conclusion

OTC derivatives did not cause the crisis, but they were at the heart of it. The OTC derivatives have had a market structure characterized by lack of transparency and neutrality, bilateral trading, limited liquidity and weaker risk management. Regulation needs to be revised to offer better incentives to the market to choose safer instruments and venues. Regulation also needs to mitigate the risks of the OTC space better.

CCPs, on-exchange trading and trade repositories, will definitely make the derivatives markets safer and avoid AIG or Lehman cases and disruption in the future. This is the price of safety.

The credit crisis shows that when markets and instruments are not safe and when risks are not correctly priced, it is taxpayers that have to cover the risks. We should work to make markets safer.