Richard Metcalfe – EP remarks – 14th April, 2010

Madam Chairman and Distinguished Members of the Committee on Economic and Monetary Affairs: thank you for that introduction; and thank you for the opportunity to address [the Parliament].

ISDA's mission includes "advancing international public understanding of the business"; so we do truly welcome the opportunity to promote well informed dialogue; particularly with a body which can and no doubt will play a decisive role in shaping the future regulatory environment for financial services.

I intend to focus on supervisory transparency, where I believe we have shared objectives with the legislative and supervisory community and where I believe we can productively work together.

I also intend to keep my initial remarks very brief, for two, related reasons:

1) To focus on the key issues – I believe that by clarifying the main conceptual and practical points, we establish a sound basis for any more detailed discussions;
2) To allow as much time as possible for *your* questions, whether on details or the broader concepts.

ISDA is a trade association that represents the full range of parties to OTC derivative contracts. Those members share a belief that prudence and efficiency are essential for a healthy market in risk transfer that serves the broader economy – the corporate treasurers and the fund managers who use OTC derivatives to actively manage financial risks in support of their core businesses. And please be aware that the single biggest part of our membership consists of end-users of derivative contracts (a fifth of those end-users being sovereign or supranational bodies[1]). To reflect this end-user participation, that constituency is well represented on our Board.

What all of our membership agrees is that supervisory transparency can play an important role in ensuring prudence and efficiency – a vital role, in fact. It ultimately supports active involvement in OTC derivatives by the

[1] ISDA has 820 member institutions, from 57 countries. These 70-odd sovereign, quasi-sovereign and supranational entities among the membership include the Banque de France, the European Investment Bank, the Kingdom of Belgium and others from around Europe and the world.

widest possible range of participants, which ensures a ready means of transferring risk exposures.

Supervisory transparency can bring two main benefits – the policing of market manipulation (which, of course, even if it is an extremely rare phenomenon, is one that has the potential to disadvantage other market participants); and systemic oversight (which can help in monitoring the potential build-up of large exposures).

Industry is firmly committed to both these *regulatory* objectives. Indeed, it is in industry's own interest, because – left *un*supervised – either issue threatens to undermine confidence in the market as a whole, which could ultimately lead to lower use of financial services, harming that very business. Once they *are* supervised, of course, then there is no reason why the market cannot function freely, via the full range of contracts demanded by a modern economy.

One thing ISDA is *not* mandated to do is to say what sort of reporting is appropriate for sovereign nations; of what data; or to whom. So, my remarks today will be of a more general nature, regarding market integrity in OTC derivatives.

Nor will I say much about price transparency to the rest of the market. This is a quite separate issue from that of supervisory transparency, and required a very different cost-benefit analysis. For the moment, I would simply note what we consistently observe: that transparency follows the development of liquidity, and not vice versa.

In a way, the solution to issues of market integrity is quite simple, in concept at least.

1. **Transaction reporting** allows supervisors to monitor the activities of market participants, close to real-time, and to watch out for any instances of suspect behaviour – market abuse, in other words. An example of this in action is the UK, which already has a broad transaction-reporting regime that, in capturing OTC derivatives, goes beyond the formal requirements of the MiFID.

   Having such a system in place provides supervisors with a means to distinguish between true price formation – where derivatives have a

valuable role to play in ensuring a proper, ***two-way*** market – and any instances of abusive behaviour, which of course would *distort* prices.

2. As for **systemic oversight**, the emerging trade data repositories provide an overview by underlying asset class – so that information on *all* derivatives, globally on, say, interest rates, is captured in one place; and for those on credit in another; and so on.

   Since counterparty exposures can and do cross borders, it is vital to ensure that an aggregated picture is built up. And that is why a *single* repository per asset class is clearly the right solution; not just because it is cheaper for the market (which it is) but because it meets those standards of prudence and efficiency from a *supervisory* perspective.

Naturally, some of the *details* involved in ensuring transaction reporting and trade repositories may get complicated. For instance, for both types of solution, it is important to have uniformity in technical standards, such as reporting language. Fortunately, industry already began work on this 10 years ago, which is why the so-called 'FpML[2]' language is now in place for reporting information about OTC derivatives. We believe this fact should be exploited to the full in regulatory approaches.

More of a challenge, perhaps, is a trade-repository issue that ISDA has identified: the issue of data confidentiality around the reporting of customer transactions into and from trade repositories. This is something where, even though the market is willing to provide data, there are legal obstacles in some jurisdictions to doing so. We are currently working with supervisors on determining the scale of this challenge and the ways to overcome it.

In any case, we note with considerable satisfaction the opening up of DTCC data (which relates to transactions in credit default swaps) to a wider range of regulatory bodies – including those in the front-line of monitoring markets. We support this, because we believe it is crucial that qualified, market-facing oversight bodies have a clear picture of where market and counterparty exposures may be building up in the system –

[2] FpML: Financial Products Mark-up Language

where many banks may be contributing to a bubble or where one firm may be taking on too much of the market.

It is worth noting that, in the meantime, this same source (ie, DTCC) already provides us *all* with critical information about the aggregate scale of positions in credit derivatives – the risk-transfer contracts which have been the subject of so much comment in recent months (but remarkably little analysis). The data that DTCC publishes weekly clearly shows that open positions are a small fraction of total turnover; and, in practice, of the issuer's outstanding bonds and loans. This reflects the role of OTC derivatives generally, which is to adjust risk positions at the margin; while the biggest financial flows *by far* continue to be in securities, foreign exchange, commodity and lending markets[3].

Within the world of credit, as we have stated elsewhere, open CDS on Greek government bonds reference only 2% of the outstanding and reflect what is happening in those underlying bond markets rather than driving it. At the same time, for large investors, the *availability* of CDS gives them more confidence to take on bond positions, since they can use CDS to hedge those when they may need to. There is no doubt whatsoever that restricting use of CDS would lead those investors to demand higher returns, pushing up the cost of borrowing.

As an international association, with members in 57 countries round the world (and 23 out of 27 EU member states), we support effective *international* co-ordination of approach to OTC derivatives, because they represent a truly cross-border financial service – a service, in fact, that sets an example for other, more geographically limited financial markets.

A good example of international co-ordination is the work of the Basel Committee, in establishing standards for risk-based capital. These may require periodic updating but the mechanism for doing so is there.

We believe in a pragmatic approach to questions of location of key infrastructure and that, whatever the location of any one piece of infrastructure, because of the nature of this market, cross-border co-ordination is indispensable. In particular, supervisors of all major market

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[3] We note the European Commission's recent reference to the 'optical illusion' of a large market, based on the mistaken use of 'notional' amounts (7th April 2010 – Discussion Paper on Market Infrastructures Legislation)

participants should have ready access to information about the level and nature of those participants' positions.

On the issue of large exposures, incidentally, we also note that the EU has world-class legislation, in that the Capital Requirements Directive includes measures that specifically target large credit exposures. We also believe the discipline of mark-to-market accounting can be very helpful (with due allowance for hedge accounting, where appropriate).

So, while there may be much work still to do – some of it technical and some of it at the level of global political agreement – I think we can at least identity the right direction of travel and agree that we have a shared destination.

Thank you for your attention. I look forward to hearing your questions.