March 2011

AK Position Paper

Consultation document of the European Commission - Counterparty credit risk

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About us

The Federal Chamber of Labour is by law representing the interests of about 3.2 million employees and consumers in Austria. It acts for the interests of its members in fields of social-, educational-, economical-, and consumer issues both on the national and on the EU-level in Brussels. Furthermore the Austrian Federal Chamber of Labour is a part of the Austrian social partnership.

The AK EUROPA office in Brussels was established in 1991 to bring forward the interests of all its members directly vis-à-vis the European Institutions.

Organisation and Tasks of the Austrian Federal Chamber of Labour

The Austrian Federal Chamber of Labour is the umbrella organisation of the nine regional Chambers of Labour in Austria, which have together the statutory mandate to represent the interests of their members.

The Chambers of Labour provide their members a broad range of services, including for instance advice on matters of labour law, consumer rights, social insurance and educational matters.

More than three quarters of the 2 million member-consultations carried out each year concern labour-, social insurance- and insolvency law. Furthermore the Austrian Federal Chamber of Labour makes use of its vested right to state its opinion in the legislation process of the European Union and in Austria in order to shape the interests of the employees and consumers towards the legislator.

All Austrian employees are subject to compulsory membership. The member fee is determined by law and is amounting to 0.5% of the members' gross wages or salaries (up to the social security payroll tax cap maximum). 560.000 - amongst others unemployed, persons on maternity (paternity) leave, community- and military service - of the 3.2 million members are exempt from subscription payment, but are entitled to all services provided by the Austrian Federal Chambers of Labour.

Herbert Tumpel
President

Werner Muhm
Director

Executive Summary

It is necessary to avoid potential risk sources possibly leading to future crises, by introducing comprehensive regulation.

Workers have a massive interest in a robust economic development, a solid public budget and in fair wealth distribution. An important prerequisite for all of these is an adequately regulated and stable financial market.

Although the banking crisis did not directly originate from the derivatives market, this market nevertheless (in particular also the credit default swap market - CDS market) formed the vehicle based on which the subprime crisis developed into a global financial market crisis with serious macroeconomic consequences.

Apart from that it is necessary to avoid potential risk sources possibly leading to future crises, by introducing comprehensive regulation. Furthermore, the transparency of the financial market must also be significantly increased to ensure that the supervisory authority is able to identify dangers and intervene with stabilising effect in the first place.

The AK position in detail

The AK therefore welcomes the fact that the European Commission turns its particular attention to the OTC market, making proposals which are aimed at providing appropriate market incentives to move - if possible - all contracts to a central counterparty. It is also very positive that the issue of arbitrage and the problem of competition between qualifying and non-qualifying central counterparties are not being ignored.

However, from the point of view of the AK one must always keep in mind that although trading via a central counterparty (CCP) represents progress compared to unregulated bilateral trading, it is no universal remedy. The fact that immense volumes of financial capital are channelled through a central clearinghouse creates new risks, as it endangers economic stability if the clearinghouse itself gets into difficulties. The AK also doubts that the systemic risks originating from the central counterparty can be solved by the market alone. Cause for this doubt is in particular the expected competition among the CCPs resp. the competition between the trading platforms associated with the CCPs.

This problem area is described in detail in the impact assessment of the European Commission accompanying the draft proposal (COM(2010) 484) under section 7.1.3.3. The AK fully endorses the assessment contained therein. Similar to the systemically important financial institutions, attention must also be paid to the "too big to fail" problem and the moral hazard associated with it. Systemically important counterparties getting into difficulties would entail the same risk as in case of systemically important financial institutions, i.e. shifting the risk to the taxpayer, which would aggravate the debt crisis of the public budgets with the EU even more. The problem that clearinghouses could also come under the category of "too big to fail" was also addressed by the Financial Stability Board and the Basel Committee.

That is why the AK is generally in favour of

- selecting a one-tier system for Europe; hence only qualifying central counterparties may become active,

- only allowing trading of standardised contracts (introduction of a financial market MOT = minimum security standard for financial products),

- handling the entire securities trade via stock markets (and multilateral trading platforms within the meaning of the MiFID as a second-best way) and via central counterparties and

- the CCPs should - apart from an introductory phase - be independent of other financial market players. It is of particular importance to prevent a bank or another financial market intermediary from holding a controlling position at a qualifying CCP, as this would endanger both confidentiality and a simple unbundling in case of economic problems. However, vice versa the CCP should also not have a dominating influence in other enterprises ("single issue CCP").

1. Are the two conditions and the approach outlined above broadly appropriate? If not, please explain why and how they should be modified?

From the point of view of the AK, a one-tier system should be adopted in Europe, according to which only qualifying central counterparties may become active. This would be the simplest legislative method to avoid any unhealthy competition between qualifying and non-qualifying counterparties, which would probably mainly take place at fee level. The supervision of pricing by a competent supervisory authority must also be provided for to make sure that any abuse in respect of price fixing in case of high market concentration can be stopped.

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The AK welcomes the conditions proposed by the European Commission. The observation of these conditions is the prerequisite for being classified as a qualifying central counterparty for both systems - two-tier or one-tier.

It should also be considered that both types of central counterparty may only trade with standardised products as any risk assessment for non-standardised financial products has proven to be extremely difficult if not impossible. This renders the determination of the necessary collateral security difficult and the central counterparty itself becomes increasingly a systemic risk.

2. Would the two-tier system ensure the right incentive structure for banks (and, indirectly, for CCPs)? If not, why?

From the point of view of the AK, a two-tier system cannot prevent arbitrage. Therefore, preference should be given to a one-tier system of qualifying central counterparties. In the opinion of the AK it can also be expected that a - to be welcomed - strengthening of security and capital requirements in respect of the trade via a central counterparty, hence a stricter trade regulation, will not result in a shift towards over-the-counter trading (OTC trade). This would be a very undesirable consequence and can from the point of view of the BAK only be avoided by standardisation and by obligatory trading via qualified and carefully regulated platforms.

3. Would a single-tier system, i.e. one where only qualifying CCPs would be allowed to exist, be preferable? If so, could making condition 2 a legal requirement for CCPs be considered as a way of doing that? Are there any other ways in which this could be done?

Yes, as already stated above, the AK expressly prefers a one-tier system.

4. Are there any legal, confidentiality or other obstacles that would prevent CCPs to fulfil condition 2?

From the point of view of the AK, public interest in systemic security takes preference over all confidentiality considerations.

5. Are there any potential difficulties in applying this approach? If so, which?

No. The AK welcomes the introduction of quality requirements, which ensure that only qualifying financial products can be traded via central counterparties. The proposed provisions seem to be a suitable way to achieve this. However, the legislator would have to determine an obligatory minimum margin in relation to the risk involved - in addition to the before mentioned condition . The BAK is generally in favour of obliging the CCP to segregate assets and positions via specially designated accounts.

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6. Is the proposed treatment of exposures of banks accessing a CCP indirectly appropriate? If not, why?

Yes, whereby from the point of view of the AK the proposed full segregation of assets should be given preference over partial (omnibus) segregation. Only then can it be ensured from our point of view that losses by a bank indirectly participating in the clearing system are excluded.

7. Could requiring just partial (i.e. omnibus) segregation with gross margining of client positions at CCP level qualify for the same treatment as full segregation? Why?

See question 6.

8. Do you agree with the outlined approach to the capitalisation of trade exposures? If not, why?

In view of the high risk for the economy as a whole, which is associated with an endangered CCP, the AK advocates highest requirements with regard to hedging, both for the CCP itself as well as for the clearing members and their clients. Due to the complex system of interrelation, the enormous trading frequency and the high vulnerability of the market, the AK is opposed to compensating the entire replacement costs at net value.

9. Should the exception for bankruptcy-remote collateral in case of use of a qualifying CCP be extended also to collateral posted to non-qualifying CCPs, provided that the latter collateral complies with the same conditions? Why?

From the point of view of the AK, the exception should not be extended to non-qualifying counterparties, as in this case the default risk for a bank indirectly participating in the trade is not excluded.

10. Do you agree with the approach to the capitalisation of default fund contribution exposures outlined above? If not, why?

Yes, the AK welcomes this proposed differentiation, also in particular to avoid regulatory arbitrage and to set an incentive to handle transactions via qualifying counterparties.

From the point of view of the AK, it is in the public interest to set as many incentives as possible that transactions will be handled via qualifying counterparties.

11. Is it possible to improve the outlined approach by making adjustments to the Current Exposure Method? If so, how?

12. Could the outlined approach be used in a situation in which a CCP had multiple default funds covering different types of financial instruments, or would it need to be adjusted? If the latter, how?

No comment.

13. Are there any other methods for calculating default fund contribution exposures or hypothetical capital that are both simple and easy to supervise? If so, which?

The Commission also addresses the fact that it is not easy for the supervisory authority to examine the provisions for calculating appropriate default funds. The AK is therefore in favour of specifying in each case a fixed value for the different categories of the counterparty relations, instead of applying the proposed method for calculation. These values could be proposed by ESMA.

14. Is requiring bilateral capital treatment for trade exposures to a CCP whose total default fund is less than its hypothetical capital a more appropriate way to reflect the risk of being a member of such a CCP? If not, is there any alternative methodology that would allow achieving this goal? If yes, which?

No comment.

15. Should CCPs be the ones calculating the hypothetical capital or could/should this calculation be performed by someone else? If the latter, who?

From the point of view of the AK it is, because of the inherent systemic risk, which in spite of collateral security and default fund originates from a central counterparty, essential that the calculation of the hypothetical capital is subject to public supervision. The national supervisory authorities or ESMA could be considered as competent authority.

16. Do you agree with the proposed treatment of default fund contributions to non-qualifying CCPs and please explain why? In your view, what should be the risk weight associated with these exposures?

Yes, from the point of view of the AK, it is in the public interest to set as many incentives as possible that transactions will be handled via qualifying counterparties.

The AK agrees to the publication of the present position paper.

Should you have any further questions please do not hesitate to contact

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